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REGIONAL SURVEY INTEREST RATES, THE BUSINESS CYCLE AND FOREIGN EX- CHANGE POLICY

Introduction

This article examines the behaviour of primarily short term interest rates over the business cycle and in the context of the foreign exchange policy of a number of ASEAN and NIC countries. The period covered is, roughly, the last ten years. In order to ensure a degree of data consistency the study concentrates on interbank three month interest rates. There is a further advantage insofar as these rates are, in general, determined by market forces and are less susceptible to direct controls by monetary authorities. Furthermore interbank rates are sensitive to and also influence changes in other rates, such as deposit or loan rates and hence are good barometers of the overall credit conditions in money and short term capital markets. Where appropriate, or where there are developed and relatively free markets, other interest rates as well are examined.

The rapid development of the Asian regional capital and money markets, coupled with the move towards deregulation of foreign exchange and capital movements pursued by most countries, should induce a growing degree of interdependence amongst these markets. In general if the flow of funds, as well as that of goods and services, is relatively unhindered then it can be expected that interest rates in the countries involved would move broadly in tandem. This, however, is quite a strong assumption which requires qualifications in a number of ways as it is unlikely to hold in practice.

Firstly, nominal interest rates reflect the real opportunity cost (i.e. the alternative uses) of funds plus the expected rate of inflation. Assuming that the current rate of inflation is a rough guide for the future rate, then accelerating price changes will be associated with higher nominal interest rates. This proposition, however, needs to be modified by taking into account the phase of the cycle. Higher (lower) nominal interest rates could reflect a rising (falling) demand for credit on the upswing (downswing) of the cycle as well as tighter (looser) monetary policies.

Secondly, the behaviour of interest rates will be greatly affected by the foreign exchange regime. Fixed or otherwise pegged foreign exchange rates limit the ability of monetary authorities to influence interest rates other than in the direction or level necessary to maintain the desired exchange rate. For example, in the case of Hong Kong the pegging of the local currency to the US dollar in October 1983 at the rate of US\$1 = HK\$7.80 signified that Hong Kong dollar rates could not diverge significantly from their US counterparts. In the case of Hong Kong the mechanism of

the peg was expected to cause interest rates to change automatically. However, policy measures introduced in 1988 have increased the capacity of the authorities to pursue more independent interest rate policies. Countries such as Singapore and Malaysia whose currencies are pegged to a basket which contains the US dollar are also faced with similar limitations in their interest rate policies. Indonesia has followed a policy of orderly depreciation of the rupiah against the US dollar since the last major devaluation in 1986. This policy implied that short term interest rates had to be used to support the currency during periods of pressure and also during periods of rapid deregulation of the banking system. The appreciation of the Taiwanese dollar and of the Korean won against the US dollar from mid 1985 to mid 1989 was not necessarily reflected in the behaviour of domestic interest rates as both these countries have, to date, varying degrees of controls over their foreign exchange markets and/or capital movements.

The final qualification concerns the degree of market regulation, or equivalently the extent to which interest rates are determined by market forces. By definition central bank discount rates are set to reflect whatever views or policies are being pursued by the authorities. Loan and deposit rates may also be set by the authorities or by the market. Any distortions that official intervention and control generate in the market are inevitably reflected in the interbank market, particularly if taken in conjunction with the exchange rate policy. The experience of individual countries varies widely. Indonesia deregulated the interest rates payable on bank deposits in 1983, but it was only during 1990 that official subsidies to a wide class of loans were progressively withdrawn. In Hong Kong an officially sanctioned bank cartel sets interest rates for retail deposits. In Thailand official ceilings on bank loans and deposits as well as selective taxes on interest payable on foreign loans contracted by Thai resident entities complicated the process of deregulating the foreign exchange market initiated in May 1990. Finally in Korea there are still wide divergencies between the largely officially set bank loan and deposit rates and those available in the free corporate bonds market.

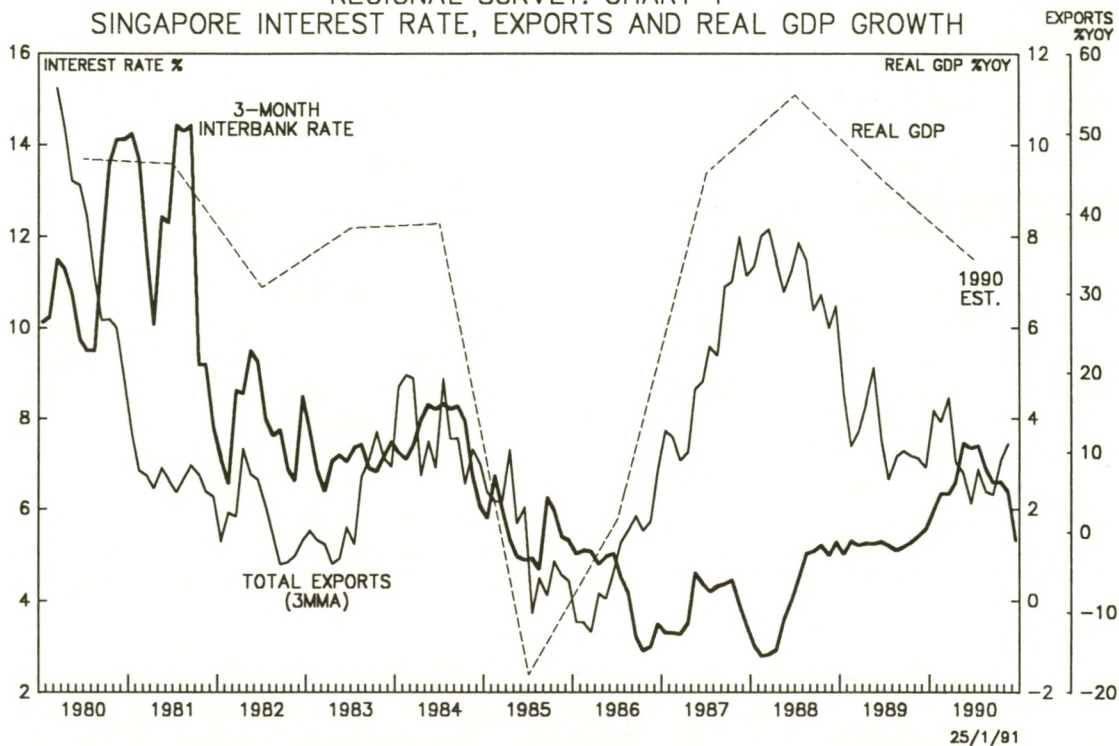
In assessing the degree of interdependence amongst the short term interest rates of these countries it is essential therefore to keep in mind both the phase of their business cycle as well as any institutional constraints or foreign exchange policies pursued.

Cyclical movements, monetary policies and interest rates

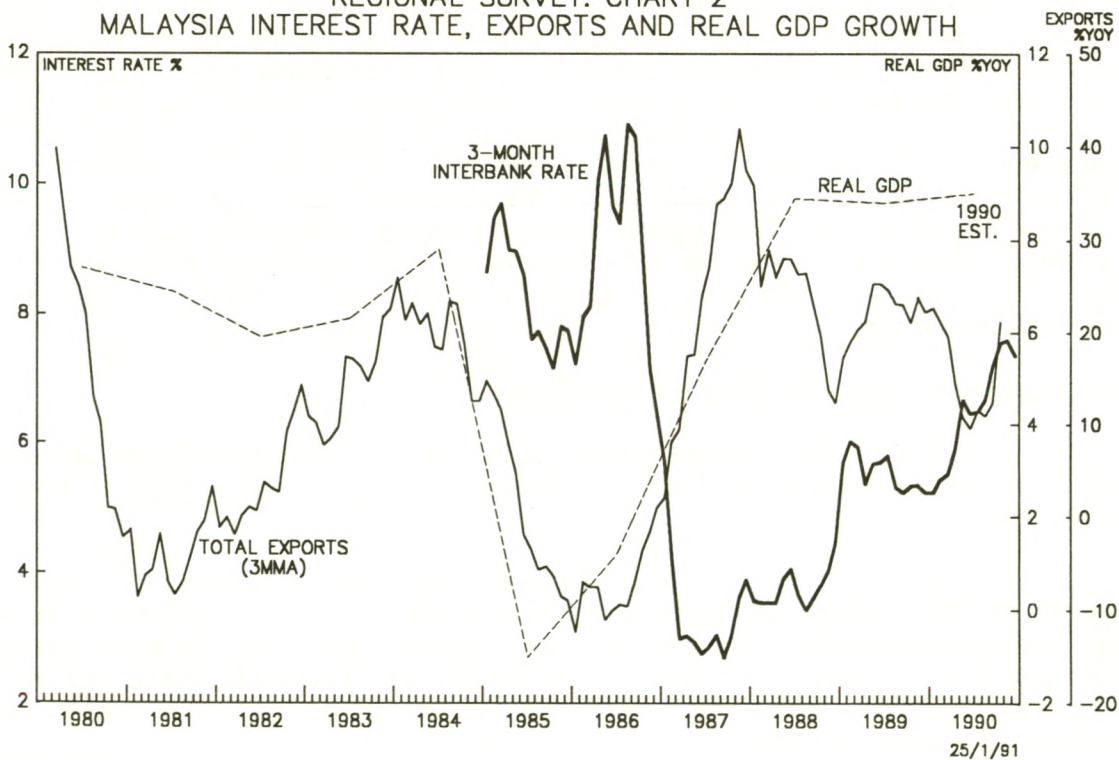
The ASEAN and NIC countries examined here are primarily export driven. Fluctuations in the rate of growth of their exports are therefore good indicators of the phase of the cycle as reflected by the rate of growth of GDP. Furthermore as GDP data for some of these countries are not available on a quarterly basis, export growth allows for a more detailed analysis of the behaviour of cycle and comparisons with interest rate movements. Charts 1-4 bring together the rate of growth of exports, GNP and the level of three month interbank interest rates for Singapore, Malaysia, Hong Kong and Thailand. Not surprisingly the cyclical movements in these macroeconomic variables coincide in broad terms, although there are periods which require separate analysis and explanation. Three examples will be used to illustrate this point.

The steep recession in Singapore during 1984-85 was primarily caused by contractionary fiscal policy which increased the government surplus resulting in a sharp fall in money growth from the end of 1983 until the third quarter of 1985 (Charts January-February 1991

REGIONAL SURVEY: CHART 1
SINGAPORE INTEREST RATE, EXPORTS AND REAL GDP GROWTH



REGIONAL SURVEY: CHART 2
MALAYSIA INTEREST RATE, EXPORTS AND REAL GDP GROWTH



1 and 5). Negative export growth lasted approximately for one year only, mid 1985 to mid 1986. Interbank rates rose and stayed high during most of 1984 because of the tight liquidity, but only fell during 1985 when the Singaporean economy experienced negative GDP growth. The rapid easing of the fiscal stance of the government during 1985 was reflected in the acceleration of money growth during 1986. The subsequent decline of interbank rates until the end of 1986 is explainable by the fact that the rate of growth of the economy was not sufficiently high yet to create an excess demand for credit. GDP growth rates achieved, and surpassed, their pre-1983 levels only in 1987.

In the case of Hong Kong the sharp "spikes" in the interbank rates during October 1984 and January 1987 reflected the policy constraints imposed by the pegged exchange rate system (Chart 3). In the case of 1984, the rise in the interbank rates reflected the pressures on the Hong Kong dollar during the time of the Sino-British negotiations over the fate of the territory. The fall in the rates during December 1987 - January 1988 resulted from pressures to revalue the Hong Kong dollar, pressures which led to the introduction, but not the implementation, of a negative interest rates scheme. It is important to note that on both occasions it took ten months to one year for the level of interbank bank rates to return to the initial level from which they either rose (1984) or fell (1987). In both these periods, the economy was experiencing strong export growth (Chart 3).

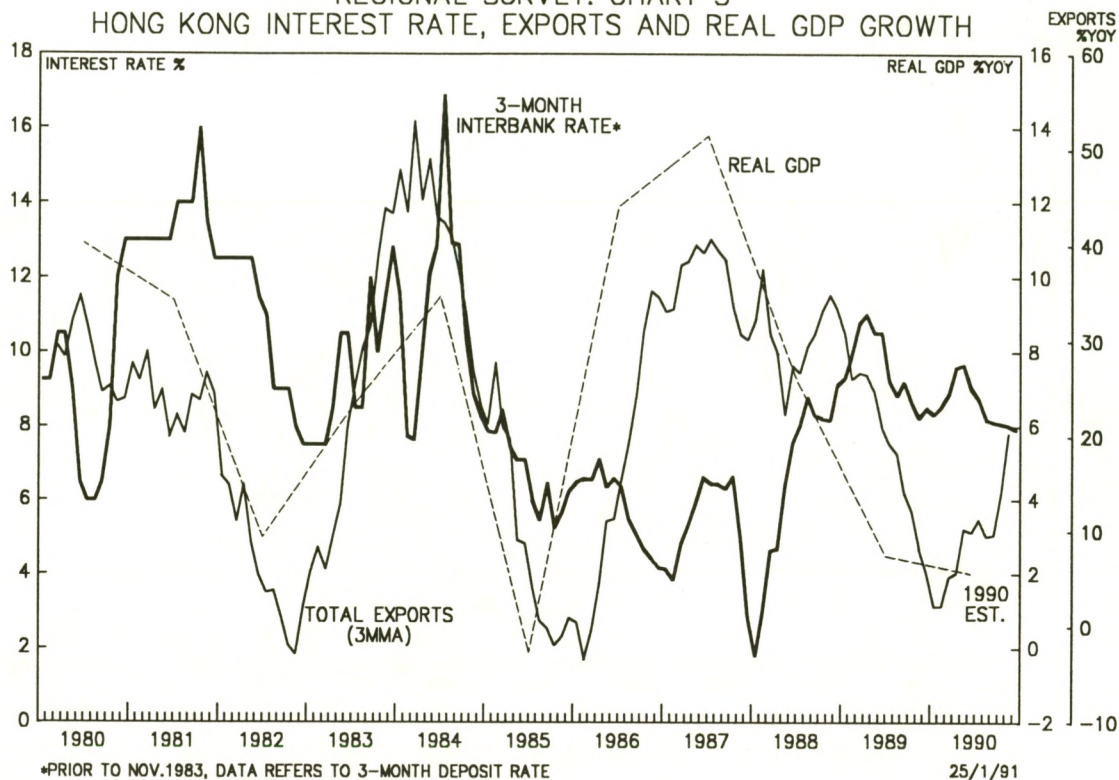
Chart 6 illustrates the experience of Indonesia during the last two years, 1989-90, with the behaviour of interbank rates reflecting institutional as well as economic developments. The deregulation of the banking system towards the end of 1988 plus the availability of reserves allowed banks to expand their credit thus leading to a sharp acceleration in the growth of money stock during 1989 and the first half of 1990. Interbank rates were on a declining trend throughout this period reflecting a potential excess supply of funds. In June 1990 the central bank of Indonesia became alarmed at these developments and the build-up of inflationary pressures. There ensued an exceptionally sharp increase in interbank rates. This had the dual purpose of curbing the growth of bank loans and of allaying fears over devaluation of the currency. The rupiah had been devalued twice in the 1980s, in 1983 and 1986. In the first case interbank rates fell sharply. The sharp rise in the interbank rate in 1987 was another response to developing pressures on the rupiah. Indonesian authorities have always tried to maintain wide enough differentials between local and Eurodollar rates in order to ensure a reasonably smooth and controllable depreciation of the rupiah against the US dollar.

Foreign Exchange Policies and Interest Rates

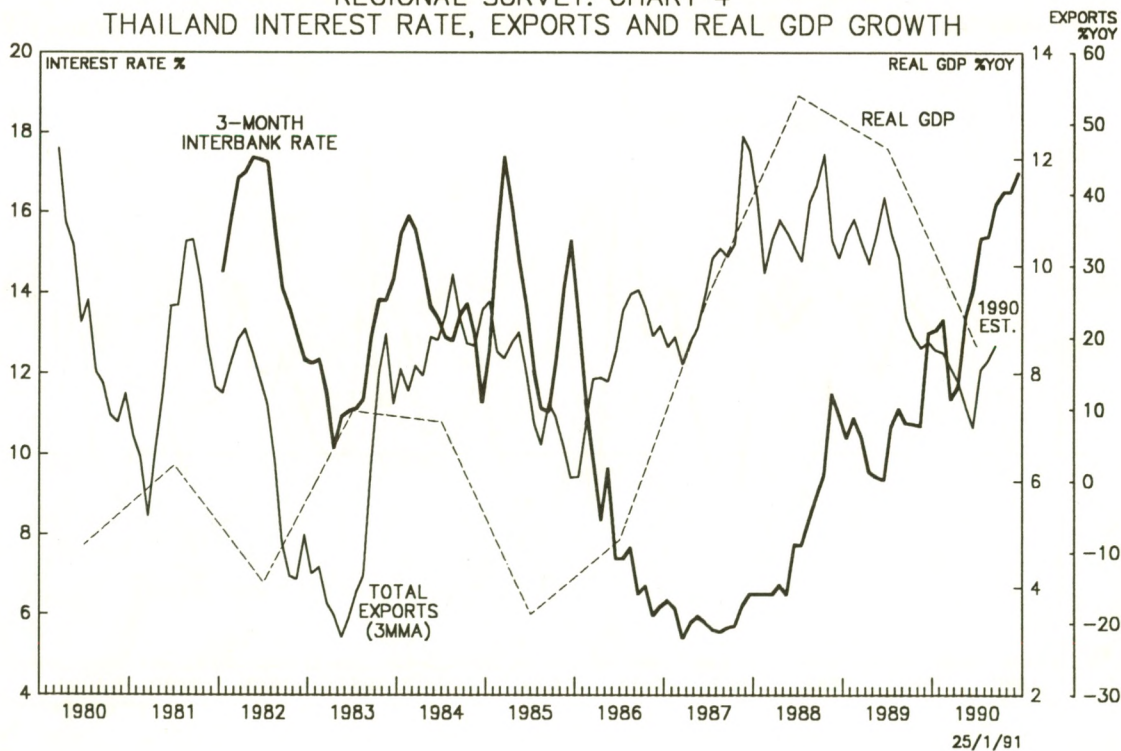
The last two examples used here to illustrate the behaviour of interbank rates involved some aspects of the foreign exchange policies pursued by the countries in question.

Charts 7 to 10 indicate the close relationship in the movements of local three month interbank rates and the three month Eurodollar rates. The countries chosen to illustrate this relationship are Hong Kong, Singapore and Malaysia whose currencies are, in varying degrees, linked to the US dollar, and Thailand because the link of the baht to the US dollar has presented some special problems for interest rate policies in the last two years.

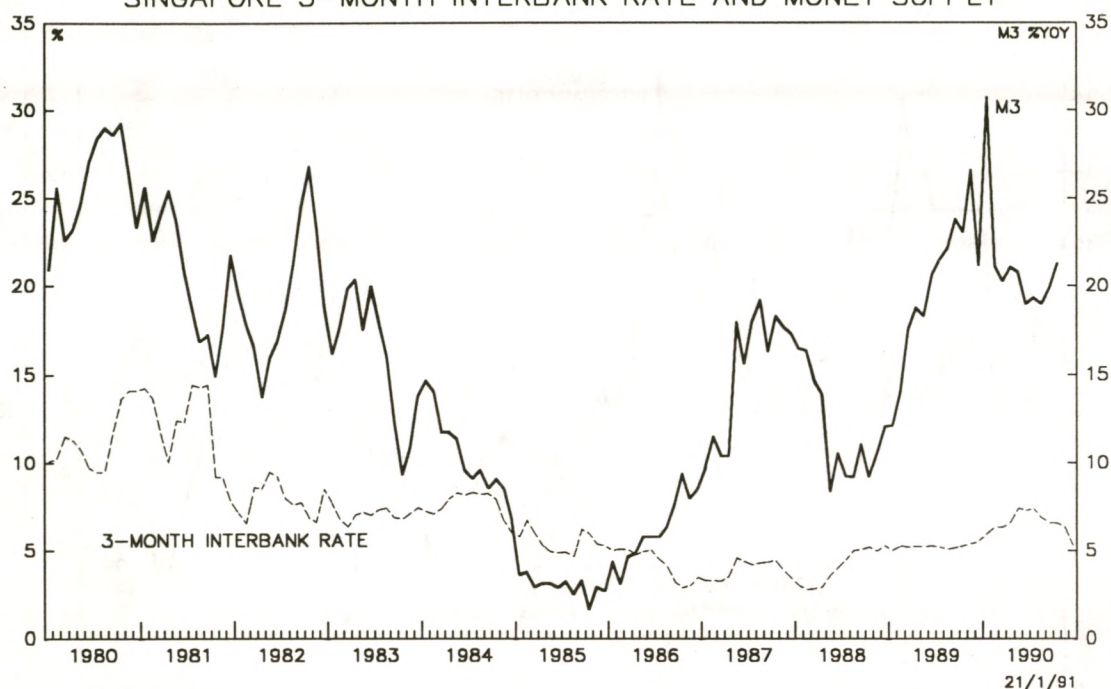
REGIONAL SURVEY: CHART 3
HONG KONG INTEREST RATE, EXPORTS AND REAL GDP GROWTH



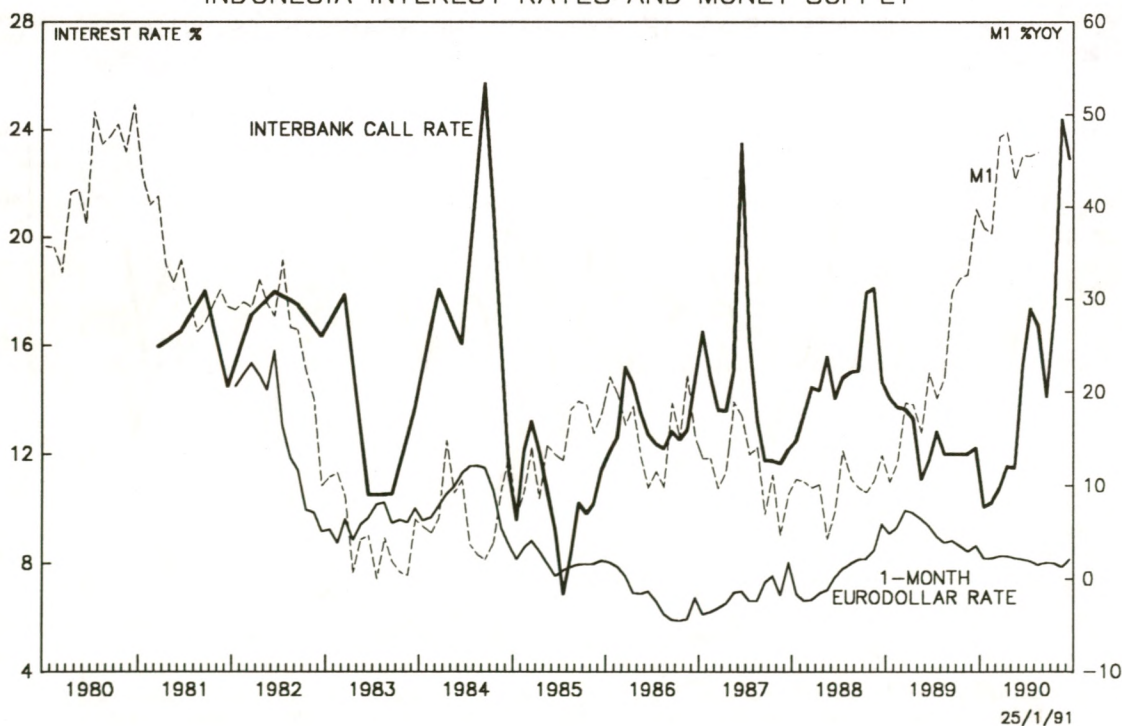
REGIONAL SURVEY: CHART 4
THAILAND INTEREST RATE, EXPORTS AND REAL GDP GROWTH



REGIONAL SURVEY: CHART 5
SINGAPORE 3-MONTH INTERBANK RATE AND MONEY SUPPLY



REGIONAL SURVEY: CHART 6
INDONESIA INTEREST RATES AND MONEY SUPPLY



of the exchange rate means abdicating control over domestic interest rates. Potentially this also means greater variability of domestic interest rates as the authorities shift the weight of their policy towards influencing the level of exchange rates. In other words, in order to defend and sustain a chosen parity, authorities may have to change interest rates frequently and over a wider range than otherwise.

Table 1 presents some basic statistics on the average levels and variability of interbank rates for the four countries examined as well as for the three month Eurodollar rates.

TABLE 1

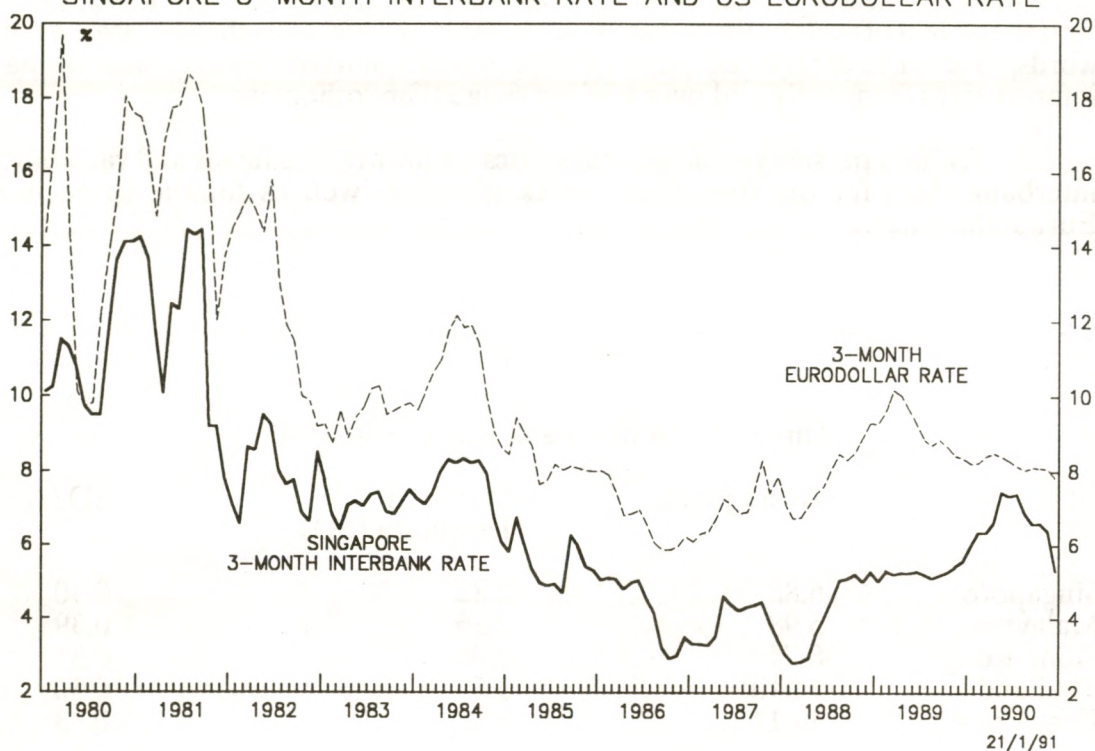
Three Month Interbank Rates 1980-1990(*)

	Average (A)	Standard Deviation (SD)	SD/A
Singapore	6.88	2.82	0.40
Malaysia	5.98	2.36	0.39
Hong Kong	8.74	2.88	0.32
Thailand	11.40	3.52	0.30
Euro\$ rate	10.11	3.35	0.33

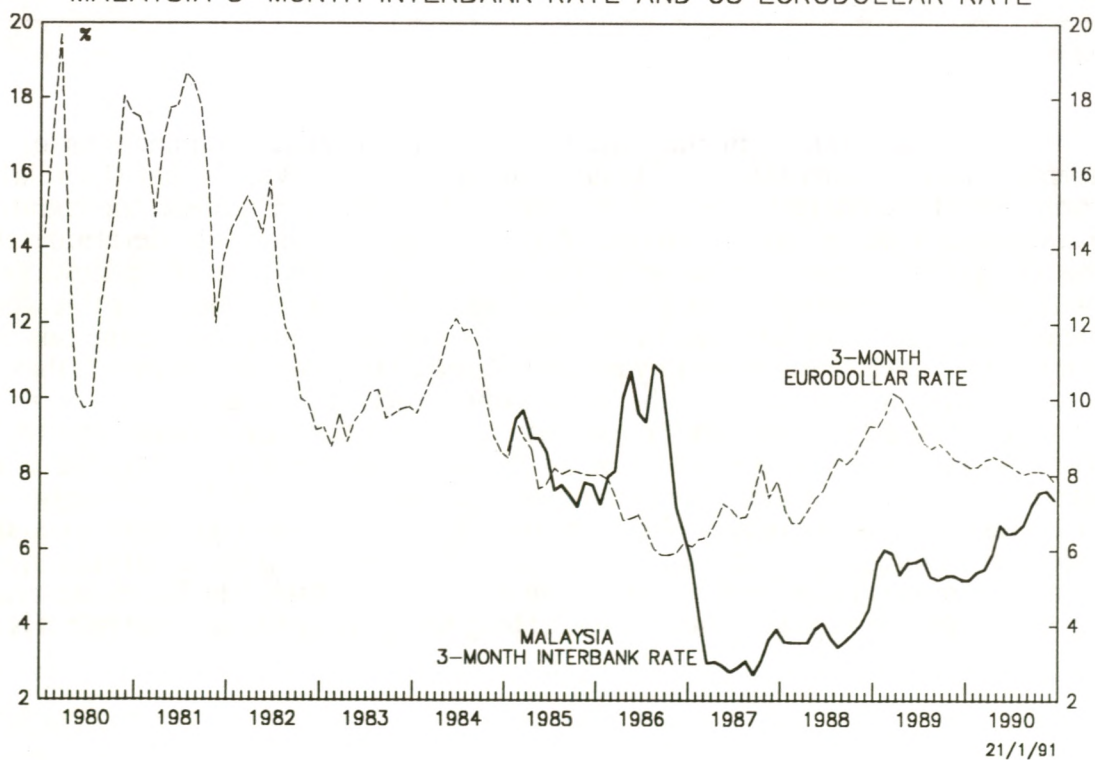
NB: (*) Average monthly figures. The time period cover for Malaysia is 1985-1990, and Thailand 1982-1990.

The differences in the time period covered makes comparisons of the average interest rates difficult. What is interesting, however, is that the relative variability of the interest rates (SD/A) is not widely different between the countries examined and the key Eurodollar rate. An additional important consideration is that the levels of local interest rates would not necessarily match those of the Eurodollar (with the possible exception for Hong Kong, see below). The reasons for this would include differences in actual and expected inflation rates, the phase of the business cycle as well as different monetary policies. It could be expected, however, that the interest rates movements would be in the same direction. Some evidence on this is offered in Table 2 which shows the correlation between the local and the 3 month US Treasury bill rates. The substitution of the latter for the Eurodollar rate is not significant as there is a very close relationship between the two. Not surprisingly there are quite close positive relationships with the US interest rates and local rates, and by extension amongst the local rates themselves. In other words the main reason why local rates move in tandem is because of their common link with the US interest rates via their foreign exchange policies. Given Hong Kong's pegged exchange rate it is not

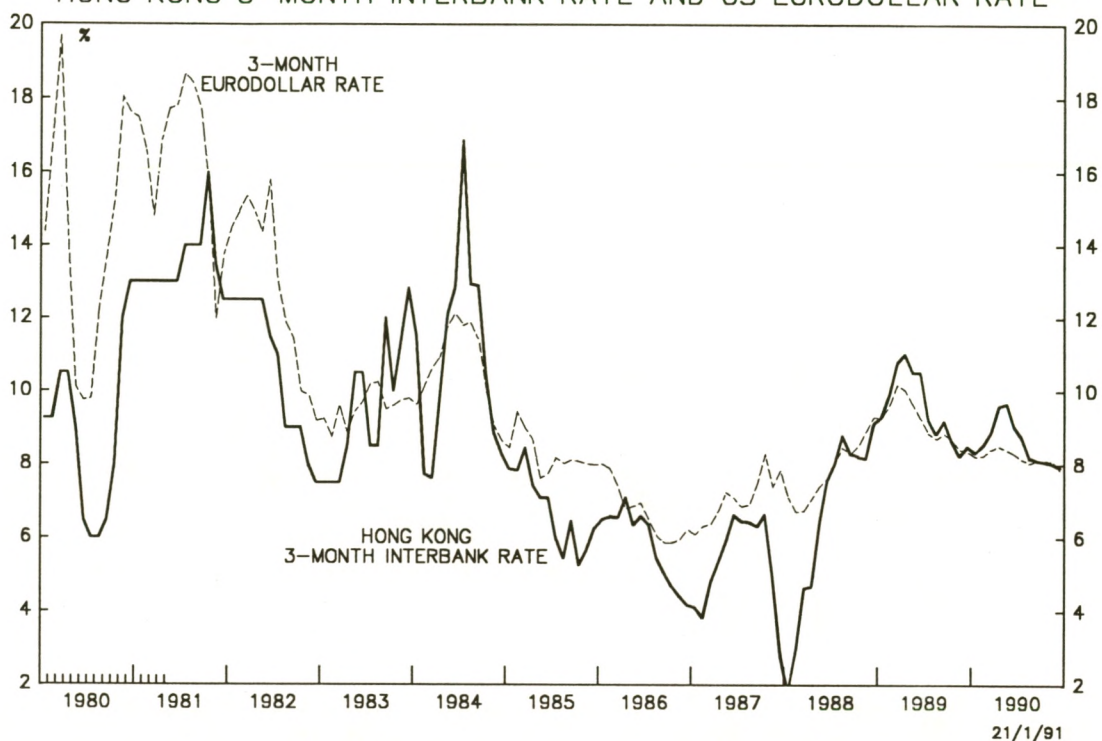
REGIONAL SURVEY: CHART 7
SINGAPORE 3-MONTH INTERBANK RATE AND US EURODOLLAR RATE



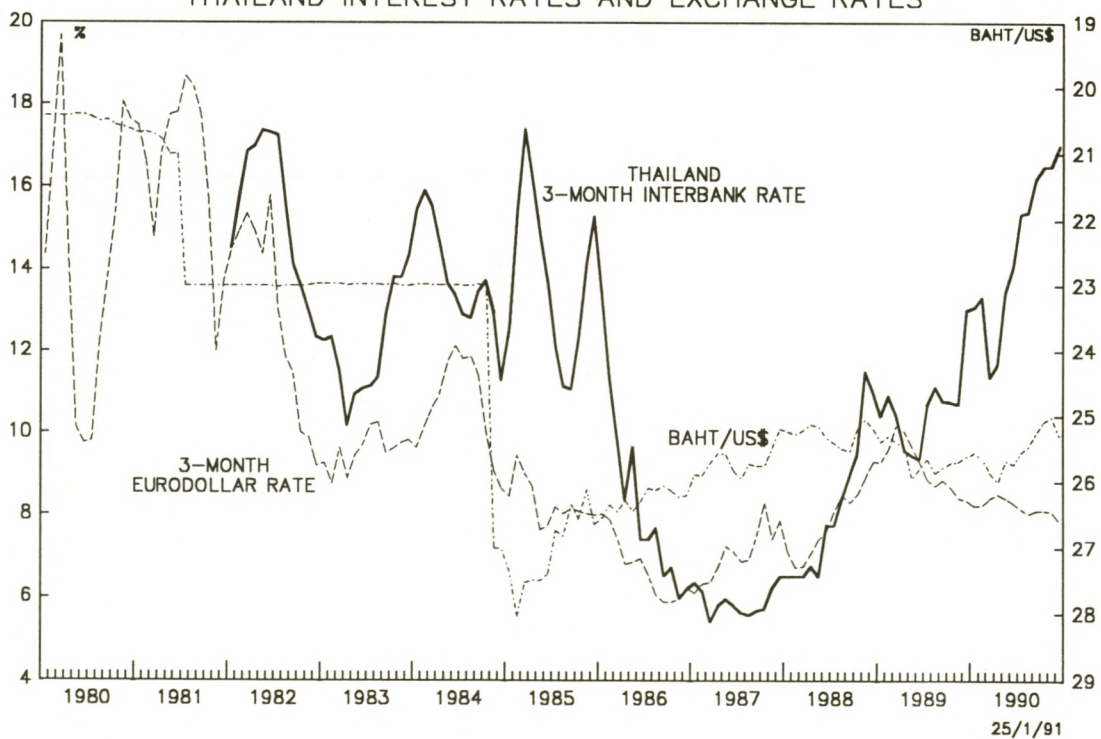
REGIONAL SURVEY: CHART 8
MALAYSIA 3-MONTH INTERBANK RATE AND US EURODOLLAR RATE



REGIONAL SURVEY: CHART 9
HONG KONG 3-MONTH INTERBANK RATE AND US EURODOLLAR RATE



REGIONAL SURVEY: CHART 10
THAILAND INTEREST RATES AND EXCHANGE RATES



unexpected that its correlation coefficient with US is the highest in the sample presented.

TABLE 2

Correlation between 3 month interbank interest rates and the US 3 month Treasury bill rate

	US	SING	MAL	HK	THAI
US	1.00	0.76	0.75	0.87	0.72
SING	0.76	1.00	0.68	0.85	0.93
MAL	0.75	0.68	1.00	0.72	0.63
HK	0.87	0.85	0.72	1.00	0.76
THAI	0.72	0.93	0.63	0.76	1.00

NB : Weekly observations, Jan. 1988 to Feb. 1990. All correlation coefficients are statistically significant at 5 per cent.

Source: P. Theerathorn "Short Term Interest Rates Linkage Amongst The Pacific Basin Markets" (mimeo), 1990.

The relatively low overall variability exhibited by the interbank rates (see the SD/A in Table 1), despite the US dollar linked foreign exchange rates, can be put to a more accurate test. In the case of Hong Kong it is possible to compare the variability of interest rates both before and after the introduction of the pegged system in October 1983. As the data in Table 3 indicate there was no significant difference in the behaviour of interbank and prime rates before or after 1983. If anything the spread in the overnight interbank rate diminished.

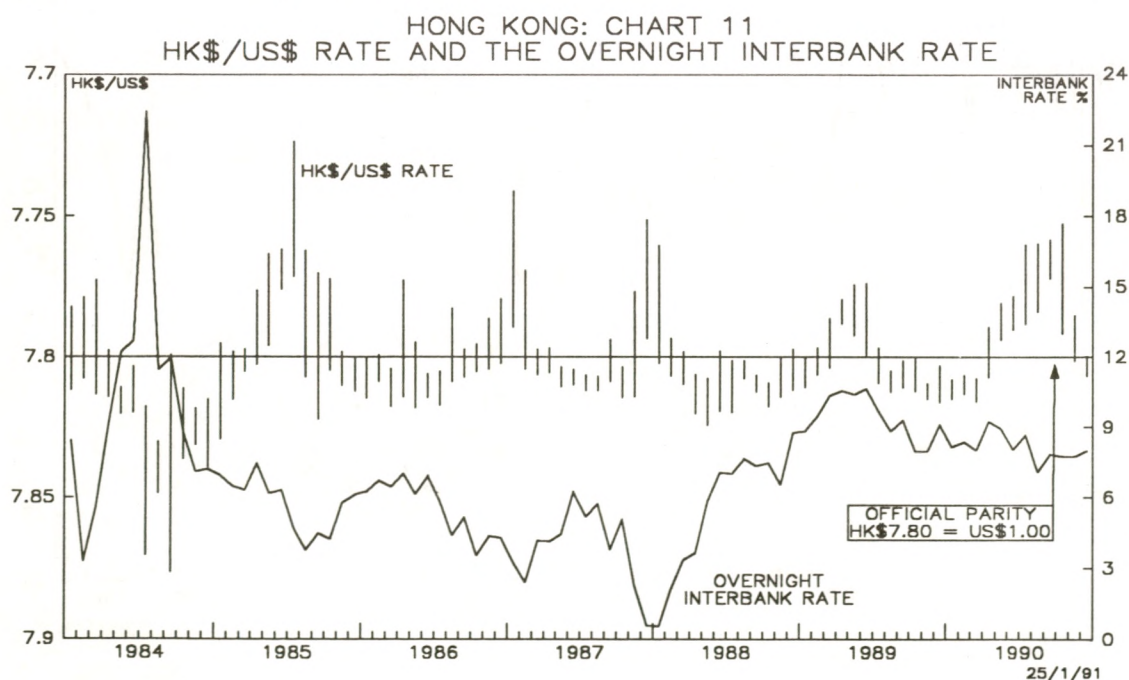


TABLE 3**Bahaviour of the BLR and inter-bank overnight rate, 1980-90**

Year	No. of changes of BLR	Average size of change (percentage points BLR)	Standard deviation of change of BLR rate	Spread of highest-lowest difference of inter-bank overnight rates
1980	11	0.27	1.26	15.50
1981	6	-0.16	1.21	13.00
1982	6	-0.91	0.34	10.75
1983	8	0.62	1.51	28.00
1984	16	0.15	1.36	47.87
1985	9	-0.55	0.64	11.50
1986	3	-0.16	0.84	14.75
1987	10	-0.01	0.86	8.75
1988	9	+0.55	0.19	9.62
1989	5	0	0.5	6.00
1990 (until Aug)	2	+0.25	-	5.38

N.B. Best Lending Rate (BLR) is the equivalent prime rate in Hong Kong. The changes in the BLR are those which occurred during the calendar year. The percentage point change refers to the previously effective BLR. The average size of change indicates that, for example, each time the BLR changed in 1980 it increased on average by about a quarter of a percentage point whilst in 1985 it fell on average by about half a percentage point.

Thailand's experience with interest and foreign exchange policies in the last 18 months is a good illustration of the conflicts which face authorities as an economy is nearing the peak of its cycle but is also experiencing mounting inflationary pressures. As Chart 4 illustrates in terms of both export and GNP growth Thailand is well past the peak and is now sliding towards a slowdown or "growth recession".

Following the devaluation of the baht at the end of 1984, Thai authorities have maintained the baht at a fairly narrow range against the US dollar (see Chart 10). In terms of its PPP value the baht was already overvalued against the US dollar after the 1984 devaluation but became increasingly so since the second quarter of 1989. The sharp increases in the interbank rates during the beginning and end of 1985 were in direct response to perceived weakening of the baht against the US dollar. As Chart 10 indicates the divergence between the Thai and US interest rates became increasingly wider since April 1989. This generated a number of problems for the Thai authorities. The policy of maintaining the baht undervalued and also effectively precluding the possibility of a revaluation, encouraged Thai residents to borrow the relatively cheaper US dollar credits, swap them for baht and onlend them in the dearer Thai market. The large inflow of foreign capital into Thailand, particularly since the first quarter of 1988, has added to the difficulties of maintaining control of the growth

of the money stock. In fact money growth (M1 + Quasi Money) accelerated from about 17% YOY at the start of 1989 to over 30% YOY by the third quarter of 1990. The Thai authorities responded in March 1990 by raising the interest rate ceilings on business loans, i.e. effectively permitting banks to charge more and simultaneously re-introduced a withholding tax on foreign borrowings. The tax is charged on interest paid and its aim is to narrow the gap between Thai and US interest rates. The further liberalisation of the foreign exchange regulations in Thailand in May 1990 made the task of the central bank in controlling interest rates more difficult if the baht was going to remain undervalued. The complications and contradictions in the interest rate policy followed are likely to worsen because the mounting inflationary pressures caused by the rapid money growth will require higher interest rates at a time when the economy appears to be well past its peak. Higher Thai rates whilst US dollar rates are on a downward path will encourage further capital inflows into Thailand, or at least overseas borrowing by Thai entities, thus making control of money more difficult. Short of reintroducing foreign exchange or capital controls, the Thai authorities will either have to allow real interest rates to fall by accepting higher inflation, which will also effectively revalue the real as opposed to the nominal baht, or of course revalue the baht.

The Hong Kong authorities themselves were also faced with a similar situation of diverging local and US interest rates. As Chart 11 shows the Hong Kong dollar appreciated from the second quarter of 1990 until the Gulf crisis of August 1990. In general during periods of appreciation interbank rates tend to fall. The positive differential between HK and Eurodollar 3 month interbank rates which developed during 1990 did not start to close until September 1990 (Chart 9). As previously indicated the authorities in Hong Kong have acquired since July 1988 instruments in the form of the Exchange Fund Account and Exchange Fund bills which allow them to conduct open market operations in the interbank market. This permits at least temporary differentials to develop between Hong Kong and the US dollar rates despite the adherence to the HK\$7.80 parity. During 1990 the authorities were concerned with mounting inflation pressure and were therefore reluctant to allow interest rates to fall faster despite the strength of the Hong Kong dollar.

Summary and Conclusions

Of the countries surveyed here the ones with relatively freer money and capital markets had, obviously, a common link through the Eurodollar interest rates. This link, however, although holding over longer periods of time, is subject to the vagaries of both the turning points of the business cycle and the degree of discretion over policies which the authorities are able to exercise.

Countries which still have exchange controls and/or restrictions on capital movements have, by definition, less integrated markets both in the regional and international sense. As the ASEAN-NIC countries surveyed are dependent on exports it is not surprising that their interest rate policies have been primarily dictated by foreign exchange movements. If there is a salutary lesson to be learned from the examples and illustrations presented here, is the seeming unwillingness or incapacity of the authorities to comprehend that even in fairly closed and controlled markets it is not possible to set or manipulate both interest and the foreign exchange rates.

The prospects of lower interest rates in the US towards the end of the third quarter of 1990 could also initiate a possible downward pressure on the short term interest rates in the countries covered here. This is much more likely to be true for Hong Kong, but less so for Indonesia and Thailand where inflation is still preoccupying the authorities. In Singapore the continuation of easing liquidity conditions and declining interest rates will be conditioned by the behaviour of prices over the next six months.

The investment policy consequences of this analysis are, predictably, ambiguous. Stock markets do move, in general, in opposite directions with those of longer term interest rates (see AMM Vol. 14 No. 3). Movements in short term interest rates could be interpreted by the stock markets as presaging changes in monetary policy and variations in the availability of credit. As Table 2 has shown there is substantial correlation between the movement in interbank rates across these countries. The data in Table 4, however, tell a different story insofar as there is very weak correlation between stock market returns in the countries examined. It would now also follow that despite the existence of links in interest rates via the Eurodollar rates there is no indirect cross link with stock returns. A caveat must be entered here as the time periods covered in Tables 2 and 4 are different, and that the cross-correlation of stock market returns is known to change rapidly over time. For example, the extremely low correlation coefficients for Thailand are probably the outcome of the relative state of underdevelopment of the Bangkok stock exchange, a situation which changed rapidly after 1986.

TABLE 4

Equity Returns Correlation Matrix 1977-88

	US	Sing.	Mal.	HK	Thai.
US	1.00	0.15	0.28	0.15	0.02*
Singapore	0.15	1.00	0.66	0.42	0.07*
Malaysia	0.28	0.66	1.00	0.30	-0.004*
Hong Kong	0.15	0.42	0.30	1.00	0.06*
Thailand	0.02*	0.07*	-0.004*	0.06*	1.00

NB : The returns were calculated from the relevant stock market indexes using weekly data.

* Signifies coefficients are not statistically significant different from zero.

Source: Y.L. Cheung and Y.K. Ho "The Intertemporal Stability of the Relationship Between Far East Equity Markets and Developed Equity Markets" Conference Proceedings on Asian Pacific Financial Markets, 1989.

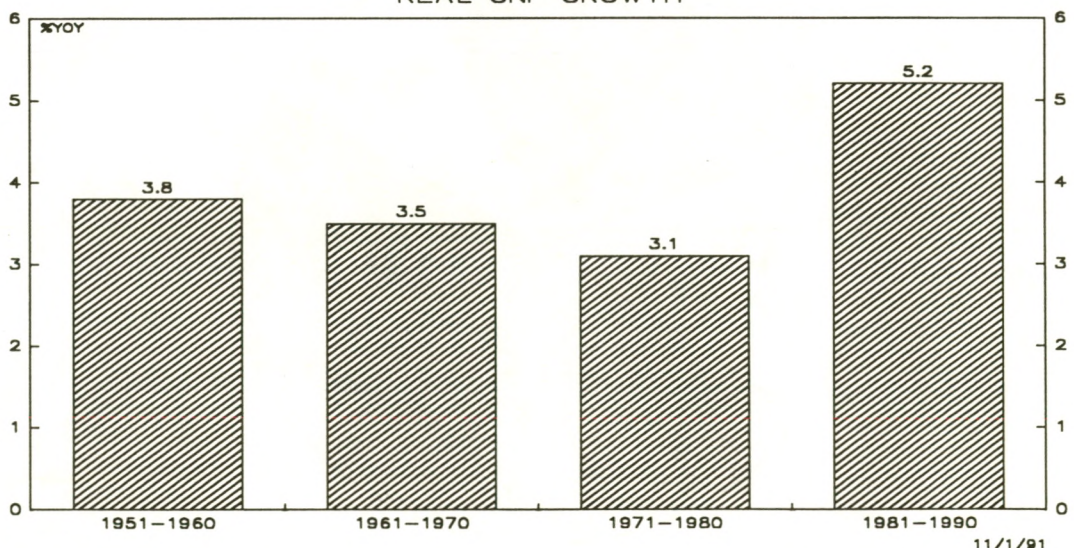
Investing in some of the South East Asia stock markets can provide for balanced, diversified portfolios given the low correlation amongst the index movements. The money markets, however, appear to be partially insulated from the capital and equity markets as their movements are dominated by foreign exchange considerations which in its turn explains their close cross correlation. An additional complication to this relation may well be purely cyclical factors. ASEAN and NIC countries do not have synchronous business cycles (AMM Vol. 14 No. 4) and movements in foreign exchange rates do not, at least in the short run, follow necessarily the overall cyclical direction.

INDIA POLITICS AND A TALE OF TWO DEFICITS

India is the world's largest democracy with a population of 800 million growing at 2% per annum. This huge source of labour fuels a large and expanding domestic market that by and large insulates India from the patterns of growth in other economies. The labour is cheap and well educated (India has around 15 million graduates and a 50% literacy rate), and there exists a sizeable, entrepreneurial middle class.

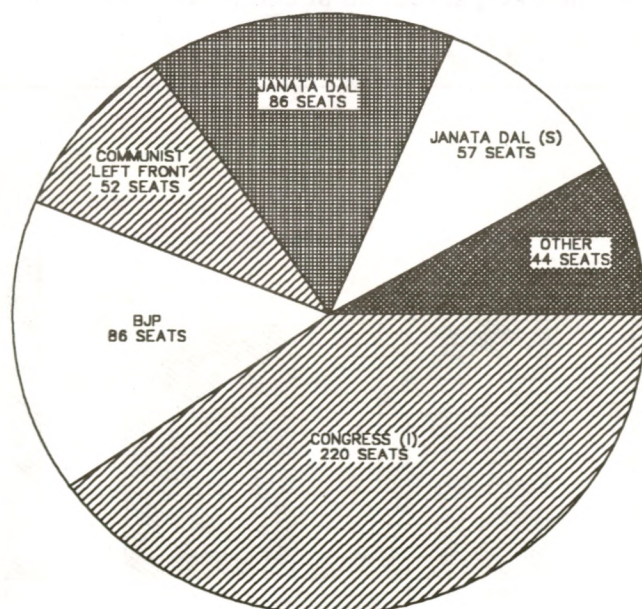
The Indian economy has grown at an average of 5.2% per annum since 1981 (Chart 1) and despite the Gulf crisis should register growth of around 4% over 1990. This compares to the period 1951-80 when the average growth rate was only 3.5%. The acceleration of growth owes much to the liberalisation programme of Rajiv Gandhi which was continued by V.P. Singh, formerly Gandhi's finance minister. When Gandhi assumed power in November 1984 following the assassination of his mother, Indira, he inherited a country shackled by the constraints of Central Planning since Independence in 1947. Although over this period India had succeeded in becoming self-sufficient in food production, the myriad of bureaucratic controls and regulations had seriously retarded industrial growth. Indian industry had insufficient, poor and often outdated capital equipment and was highly uncompetitive due to policies of state subsidisation of loss-making enterprises, import restriction and forced import substitution. A measure of the failure of Central Planning is a comparison of India's per capita income growth with that of other Asian economies. For example, at the time of Independence, India's per capita income was similar to that of Thailand and South Korea. Today, per capita income in India of \$300 is only a quarter of Thailand's and less the one tenth of Korea's. Gandhi's New Economic Policy set about freeing the economy and encouraging individual initiative. Reforms included deregulation and privatisation of industry, cuts in taxes, duties and tariffs, and the lifting of certain restrictions on investment and imports. Nevertheless the path of economic liberalisation still has a long way to run as India remains a highly protected, bureaucratised society. This article surveys the current economic and political climate in India and examines the likely direction of economic policy and reform.

INDIA: CHART 1
REAL GNP GROWTH



An assessment of India's economic situation is not possible unless put in the context of the volatile and fluid political environment. It is therefore necessary to give an outline of the major issues, political parties and personalities in India today. India is a federal republic with 25 states and 7 union territories. It has an elected president and a bicameral parliament. The lower house, the Lok Sabha has 545 members and is the main law making authority. Currently there are 5 main parties or groupings (Chart 2), none of whom can command a majority alone. Since November, the Prime Minister has been Mr. Chandra Shekhar, leader of the breakaway party Janate Dal (S) (S stands for Socialist). Shekhar is a neo-marxist, career politician who rules as a feudal lord in line with his upper-caste, rural, landed background. He is an expert coalition builder and has good contacts within his patron party, the Congress (I) of Rajiv Gandhi. His Deputy Prime Minister, Mr. Devi Lal draws his support from the agricultural lobby and can be expected to champion strongly the rural cause. Lal was responsible for the previous administration's policy of writing-off small agricultural loans. Shekhar is kept in power courtesy of the support of the Congress (I) although they have not joined the government. In this way, Gandhi hopes to influence policy while distancing himself from the decisions until such time as he feels ready to withdraw support and fight fresh elections. With the constant threat of a Gandhi veto, not much was expected of the Shekhar government in the way of either policy or duration. However, thus far people have been pleasantly surprised at its performance and it seems it may survive longer than some expected -- perhaps well into 1991. Some have argued that Shekhar has little to lose by taking difficult decisions but recently he may have started to show his true colours raising indirect taxes and saying he favours further tax rises as the way to trim the overlarge budget deficit. He has also started to replace top civil servants with others who are more malleable and sympathetic to his policies. Shekhar is a return to the old "5% growth and the atom bomb" model where growth is generated internally via Central Planning, and imports and foreign investment are discouraged. He sincerely believes that the failure of socialism worldwide has been due to incorrect implementation but it will work in India.

INDIA: CHART 2
POLITICAL GROUPINGS IN THE LOK SABHA



Shekhar came to power with the fall of V.P. Singh's Janata Dal party. Singh had continued to liberalise the economy but fell because of two issues. Firstly, in an attempt to build a vote bank, he proposed the reservation of 49.5% of government jobs for "backward" castes. This led to widespread disturbances and protests which are still continuing, while the legislation is being scrutinised by the courts. Secondly, the Bharatiya Janata Party (BJP), and its president Mr. L.K. Advani, publicised an old campaign to construct a temple to the Hindu God Rama on the site of a mosque in Ayodhya. In an avowedly secular country that is 80% Hindu, an oft heard complaint is that Muslims receive special treatment (polygamy is legal for Muslims but not Hindus for example). The BJP has fanned this discontent and used the temple as a rallying cause. Singh chose to take the stand for secularism, deploying troops to prevent the demolition of mosque. In this he was successful but he was subsequently defeated in a vote of no-confidence in the Lok Sabha. However, the issue refuses to die and the BJP has skillfully played the Hindu-Muslim divide to the extent that it would be the single largest party should elections be held today. A BJP government would be desirable on economic grounds as they have the most free market manifesto of any of the parties, but a question remains as to the influence of the RSS, an unpleasant, fascist, Hindu fundamentalist outfit which has traditional links with the BJP.

With the fall of the V.P. Singh government, the BJP was asked to lead a new coalition but declined. It was only after Congress (I) similarly declined that the President Mr. Venkataraman reluctantly turned to Mr. Shekhar. The reason for the unwillingness of both the BJP and Congress (I) to take office is that they would be unable to govern effectively without forming a new coalition. Furthermore, whoever is in power needs to take some tough policy decisions on a wide range of issues. The country is divided even more than ever on lines of caste and religion, as well as by party and location. The rural-urban divide remains and there are ongoing disputes with Pakistan and Sri Lanka as well as separatist uprisings in Kashmir, Punjab and Assam. All parties agree on the need for positive action but the unpopularity derived from taking this action is likely to make the incumbent unelectable.

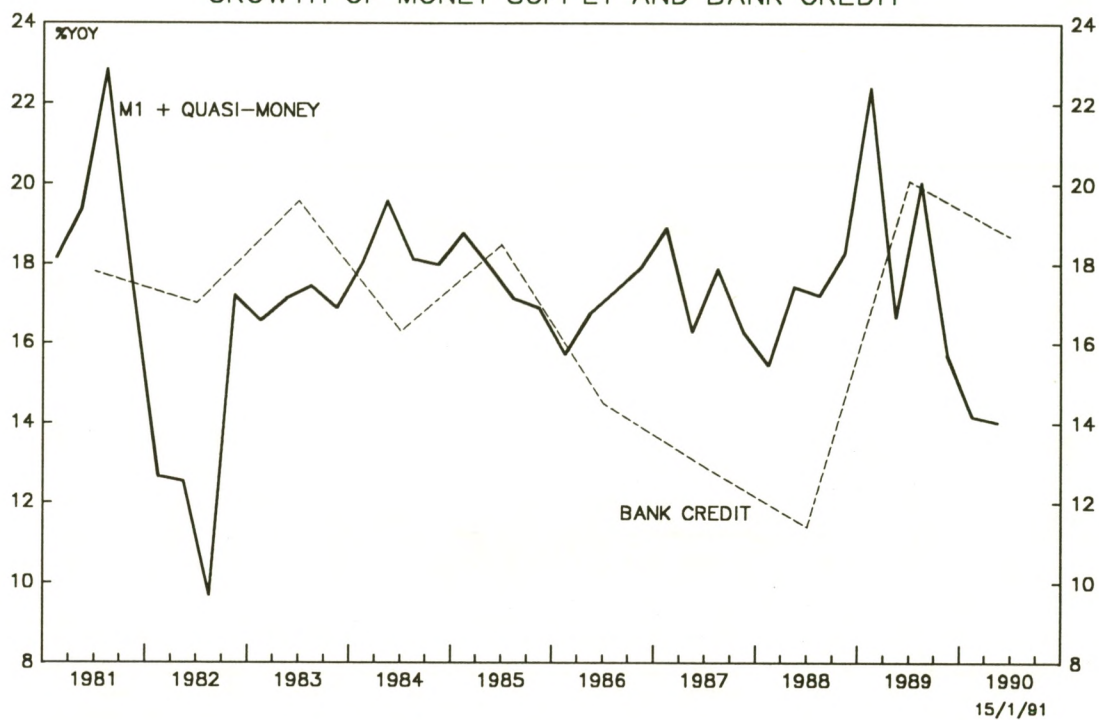
Given the current political situation and the paralysis of the decision making process, it is easy to see why the economy has received less than its due attention in recent months. Nevertheless, India is also facing a series of mounting economic problems which also require urgent attention. These problems stem mainly from the growing twin deficits of the current account and the government budget. In addition, the country is suffering from a severe lack of foreign exchange, mounting inflationary pressures and widespread production bottlenecks caused by a shortage of inputs, inefficiency and poor infrastructure.

From 1985 to the end of 1990, monetary policy was presided over by the governor of the Reserve Bank of India (RBI), Mr. R.N. Malhotra, formerly of the IMF. During this period he oversaw the transition of the RBI from a tightly controlled central monetary authority to a more autonomous one. Concurrently, reforms in the banking system saw an expansion in banking activities from traditional lending and borrowing to areas such as merchant banking, mutual funds and leasing. Rules governing the deployment of credit were simultaneously relaxed although certain "priority" sectors such as agriculture still take precedence in the allocation process. It is therefore to the governor's credit that during this period of deregulation the growth of bank lending and of all of the money supply aggregates has consistently been kept below 20% per annum (Chart 3), enabling inflation to remain generally under 10% per annum (Chart 4). The one blot on his record is the surge in money growth at the end of 1988 which resulted in rising inflation during the last quarter of 1989 and over the first half of 1990. The RBI exercises its control over monetary policy by internally deciding on targets for broad money supply growth. It then uses its control over the structure of interest rates, and more importantly adjusts the level of the Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR), to inject or drain liquidity (Chart 5). Currently, the CRR stands at 15% of bank deposits while the SLR remains at a high 38%. The structure of interest rates is being gradually freed. Call money market rates have been freely floating since October 1988 and short term instruments such as commercial paper and CDs were introduced in 1990. However, the RBI and the government still retain control over yields on treasury bills and government bonds, and have maintained the rate at which the RBI lends to banks at 10% since the mid 1970s. In addition, there is a floor on commercial lending rates, currently 16.5%, which replaced the previous 17% ceiling in 1989. The RBI has been criticised for its reluctance to use interest rate policy more actively as a method of monetary control, such as in its failure to raise the commercial rate floor and thus to mop up excess liquidity during 1989. However, it must be remembered that the RBI does not enjoy complete autonomy and political expediency often wins over economic sense. Rates were not raised during 1989 as the government did not wish to slow a booming domestic economy. Similarly, although the RBI complained bitterly, it was forced to accept V.P. Singh's reckless policy of writing-off small agricultural loans.

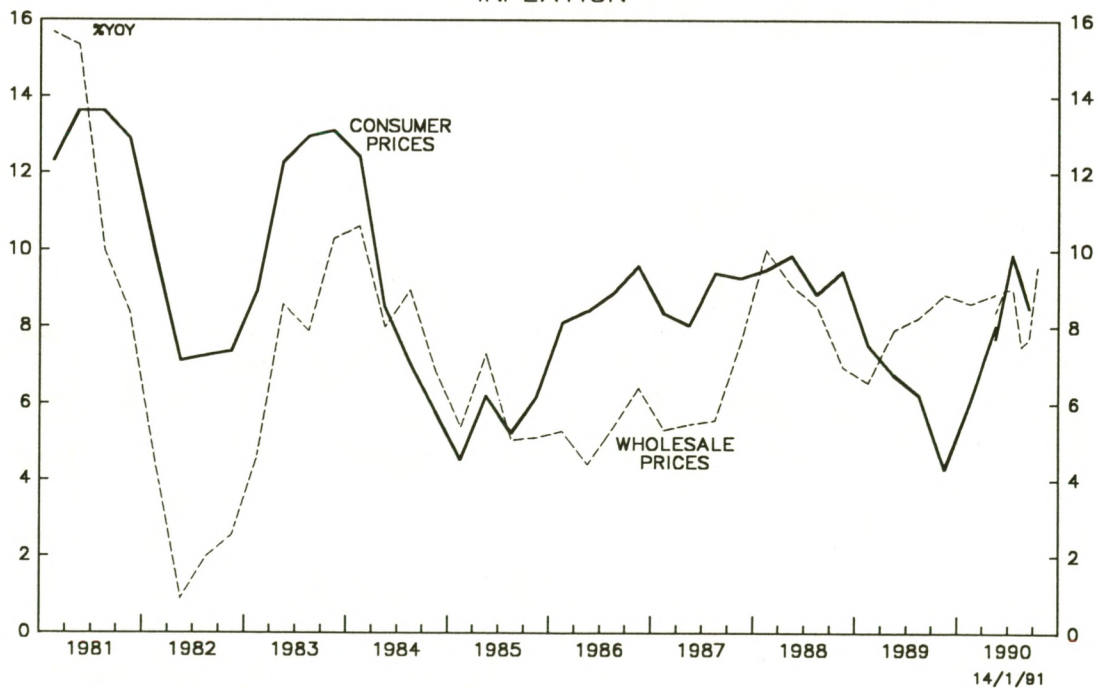
The RBI has been helped in its attempts to control inflation during the period of deregulation by a rising savings ratio which remains in excess of 20% (Chart 6). This is reflected in the growth of bank deposits and the almost continuous fall in money velocity (Chart 7). As the attractiveness of holding financial assets has increased, people have shifted out of holdings of currency, jewellery and gold, often involving the blackmarket, and into other asset classes. Chart 8 shows the shift in the distribution of personal savings, excluding holdings of physical assets which invariably account for around 40% of total savings. Notable is the rise in holdings of government bonds reflecting the widening budget deficit, and the growth of holdings of shares, debentures and unit trusts. It is estimated that India now has 25 million shareholders.

The one area of monetary policy over which the RBI has no control, much to its chagrin, is the 100% monetisation of India's budget deficit. A budget deficit is said to be monetised when the Central Bank prints money to buy the bonds with which the government pays for its deficit. Monetisation therefore denies the RBI of the tool of open market operations and results in increased money supply, and ultimately increased inflation if money supply growth then exceeds targetted levels. The growth

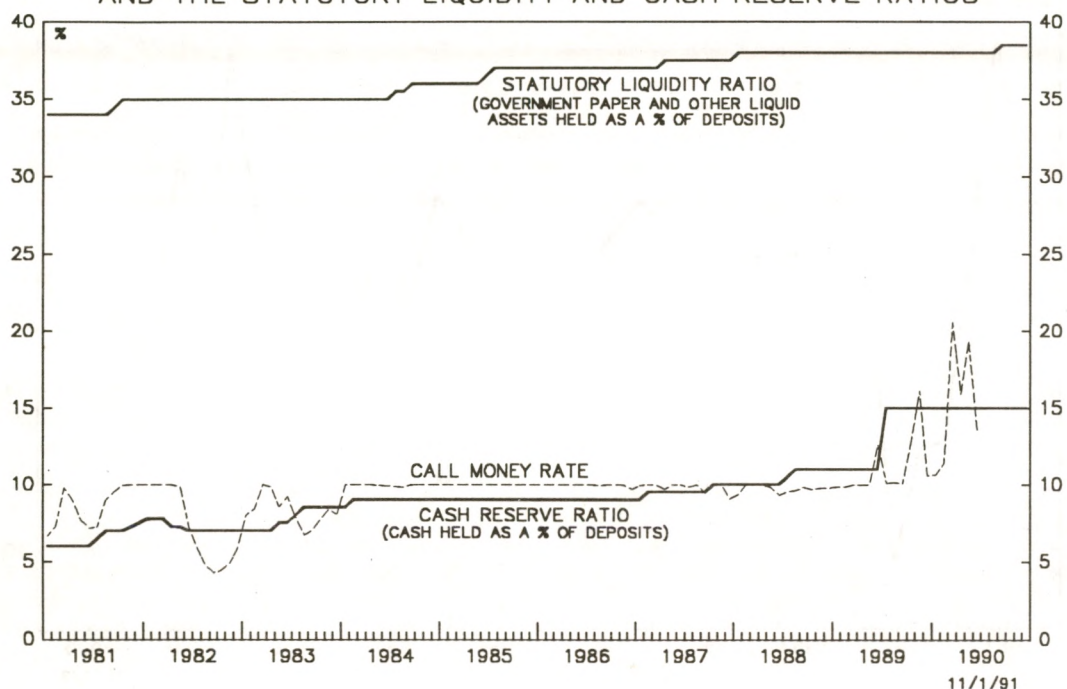
INDIA: CHART 3
GROWTH OF MONEY SUPPLY AND BANK CREDIT



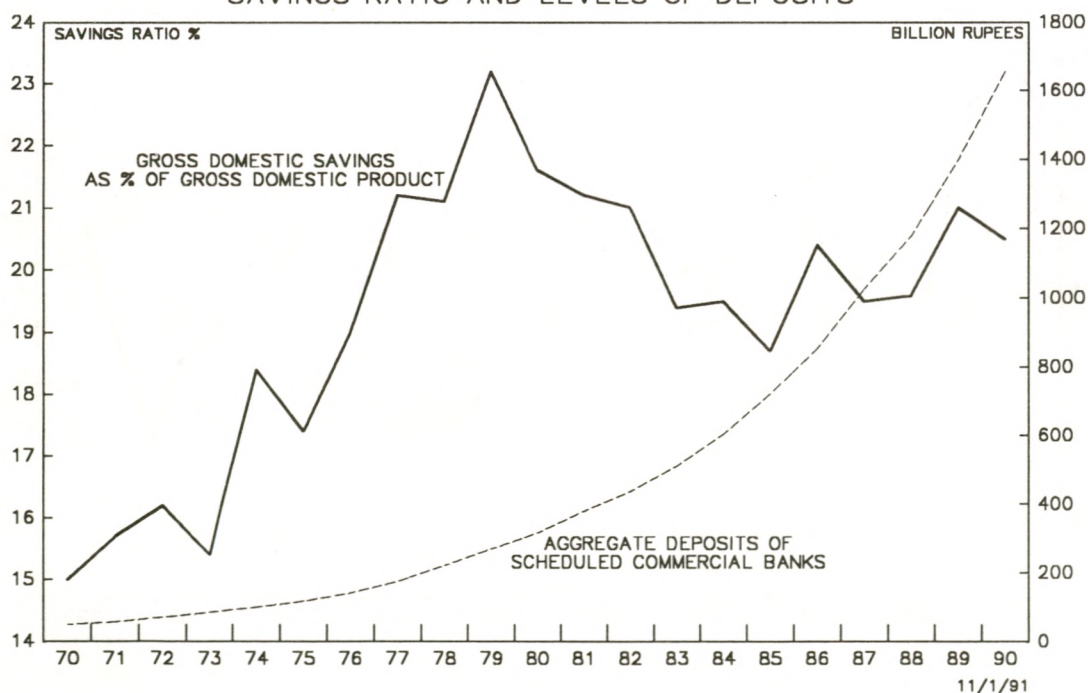
INDIA: CHART 4
INFLATION



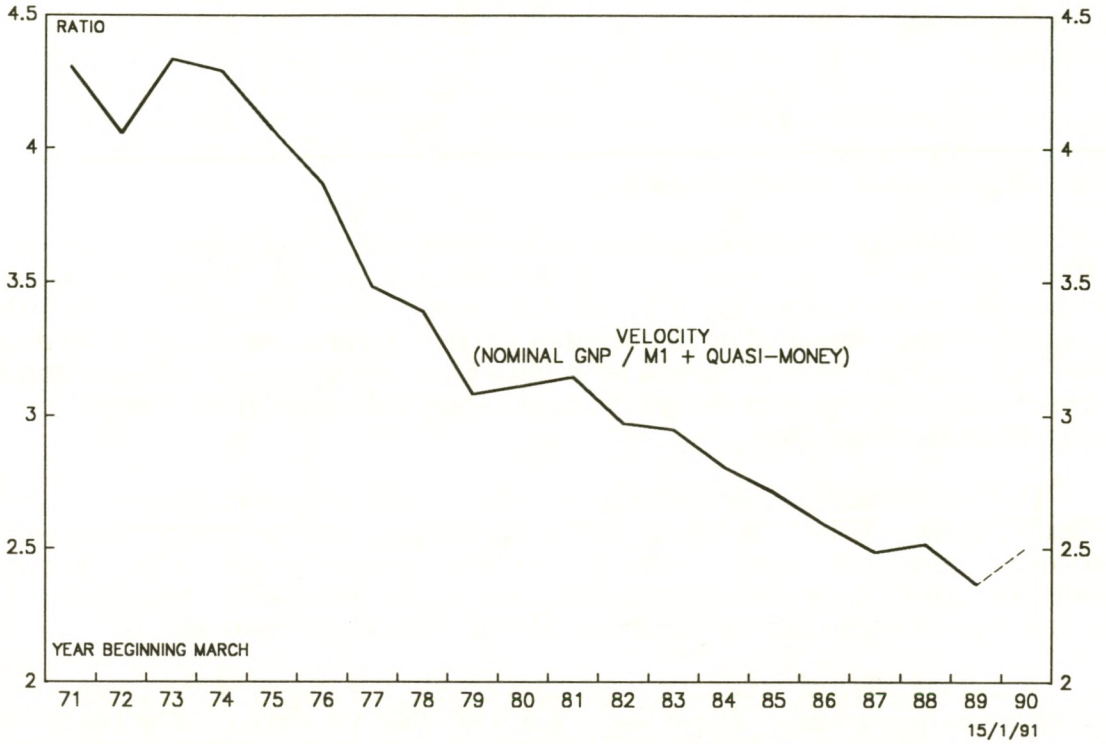
INDIA: CHART 5
INTEREST RATE ON CALL MONEY
AND THE STATUTORY LIQUIDITY AND CASH RESERVE RATIOS



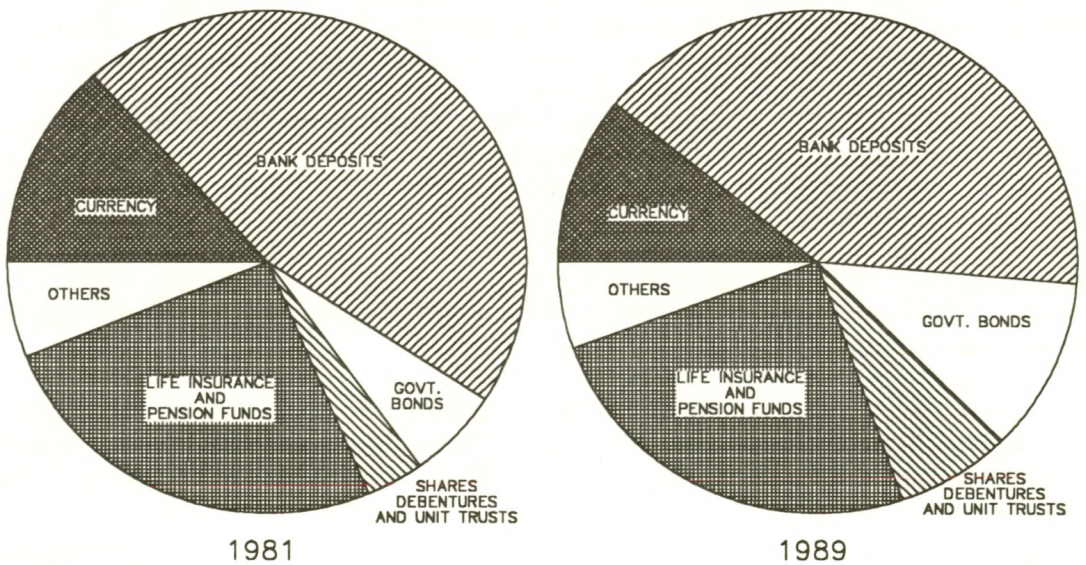
INDIA: CHART 6
SAVINGS RATIO AND LEVELS OF DEPOSITS



INDIA: CHART 7
VELOCITY



INDIA: CHART 8
DISTRIBUTION OF PERSONAL SAVINGS



of the budget deficit to around 3% of GNP is one of the most worrisome aspects of the Indian economy (Chart 9). The concern is magnified because much of the government's spending is on wages, subsidies and debt service and not on productive investments. Most parties agree that spending must be cut but this is politically difficult given the lobbying power of some areas that absorb a huge chunk of expenditure, and the inflexible nature of others. This is demonstrated by the fact that government spending still remains well in excess of 30% of GNP, despite the reforms and deregulation of the last five years.

The servicing of India's growing foreign debt, which had expanded to almost 19% of GNP by the beginning of 1990 (Chart 10), accounts for 13% of expenditure. Despite the recent downrating of Indian debt -- from A2 to BAA1 by Moody -- the country has never defaulted on its obligations in the past and is very unlikely to do so now. Although the downrating will raise India's borrowing costs, it will still require substantial borrowings over the next year so a sharp reduction in this component of expenditure is improbable.

Defence spending accounts for another 13% of the budget and appears equally inflexible as over 70% of this figure goes on pay and pensions. Severe cuts here could provoke a mutiny. Although expenditure in 1990 has been pegged to 1989 nominal levels, it will likely rise in 1991 given India's territorial disputes with its neighbours, the various separatist uprisings and domestic Hindu-Muslim and caste unrest.

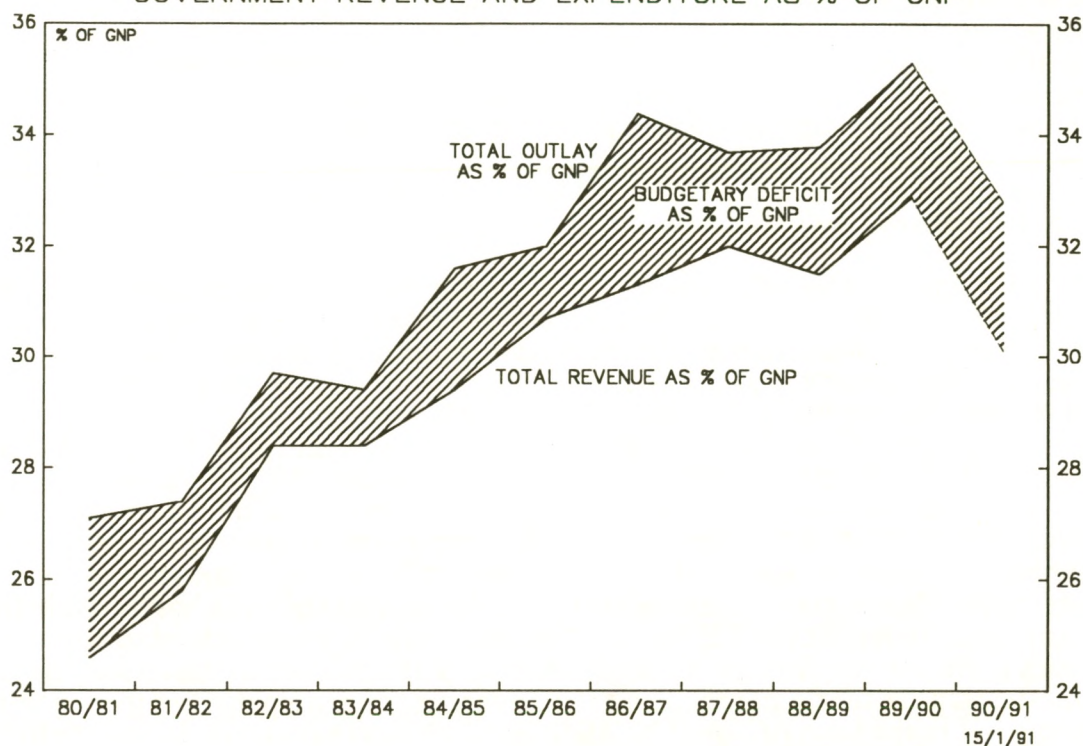
A further 10% of expenditure goes on paying the wages of the country's 10 million or so bureaucrats. These wages are 50% inflation-linked. With the unemployed already numbering in excess of 20 million, wholesale cuts here are impossible to make in the short run. A longer term commitment to cut back on India's choking red tape would make everyone's life easier and trim the deficit at the same time, but once again, politics makes this highly unlikely to occur.

The final major area of spending where real cuts should be possible is the 15-20% of the budget allocated to state subsidies and debt relief. The state subsidises a whole range of products from fertilizers to textiles as well as supporting loss making, inefficient state enterprises. The reckless policy of agricultural loan write-offs is likely to cost a further \$7 billion and has also placed strains on the banking system. Banks are refusing to advance new loans and many farmers have ceased payment on other loans hoping for a further amnesty. Others have been splitting debts larger than the 10,000 Rupees limit into amounts less than this figure and assigning the new portions to relatives. Nevertheless, this policy should only be a one-off folly and talk of cutting subsidies, notably on fertilizers, is now coming from all quarters. In addition, over the last couple of years there has been a steady stream of partial privatisations of many state enterprises. This not only reduces government expenditure, but brings in extra revenue and private sector management. The policy of selling state owned assets will probably continue and be expanded.

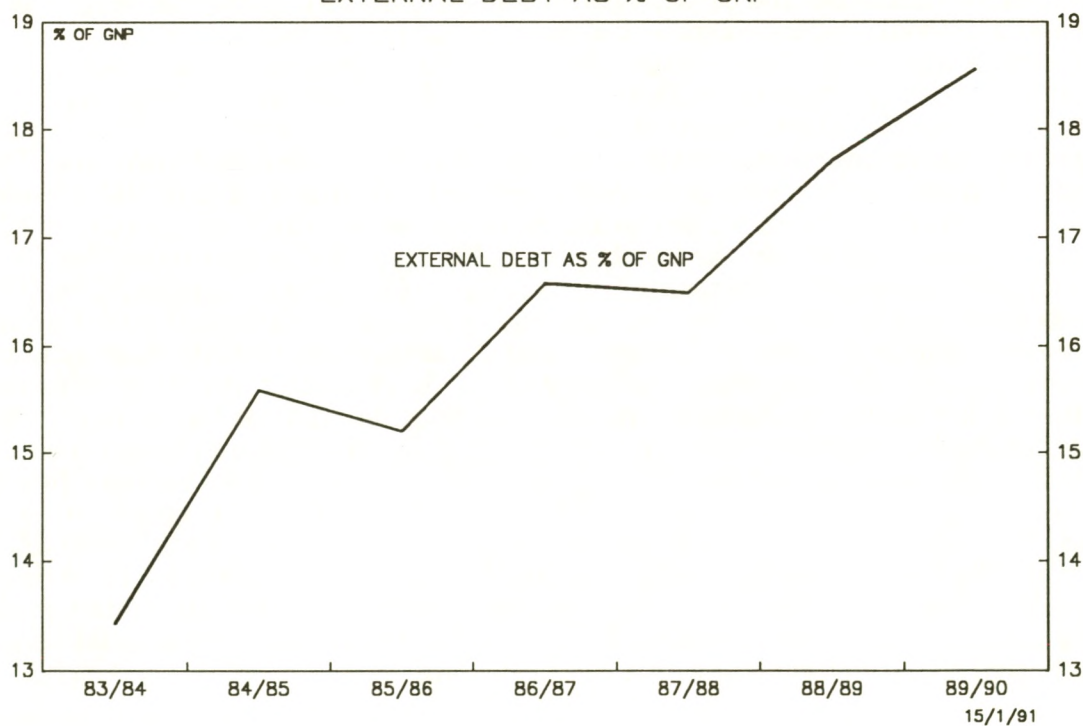
The majority of the remainder of the government budget is allocated to capital expenditure where the government needs to be spending more not less. Unfortunately it might be that cutbacks are made here while non-productive spending is left untouched.

Turning to the revenue side, the government receives only 12% of total taxes from direct income and corporation tax. Indirect sources such as customs and excise

INDIA: CHART 9
GOVERNMENT REVENUE AND EXPENDITURE AS % OF GNP



INDIA: CHART 10
EXTERNAL DEBT AS % OF GNP

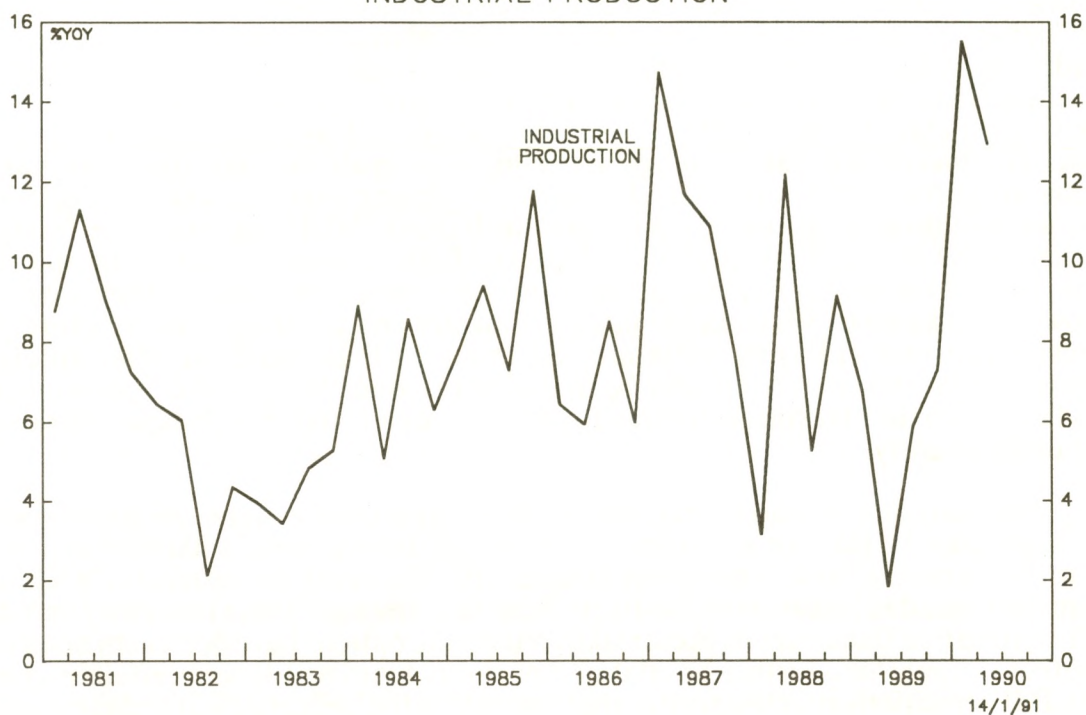


duties and sales taxes provide the remainder. Income tax brings in a paltry \$1 billion a year and evasion is widespread and little to discourage or punish tax evaders. There are therefore few incentives for people to submit correct tax returns, despite recent cuts in tax rates, and this perpetuates the existence of a substantial black market. The general method of increasing revenue has been to raise indirect taxes -- a directly inflationary policy -- rather than improve tax collection and encourage people to operate in the official market. Deregulation and a reduction in bureaucracy and government interference could help achieve this, but again the political will-power needs to be there.

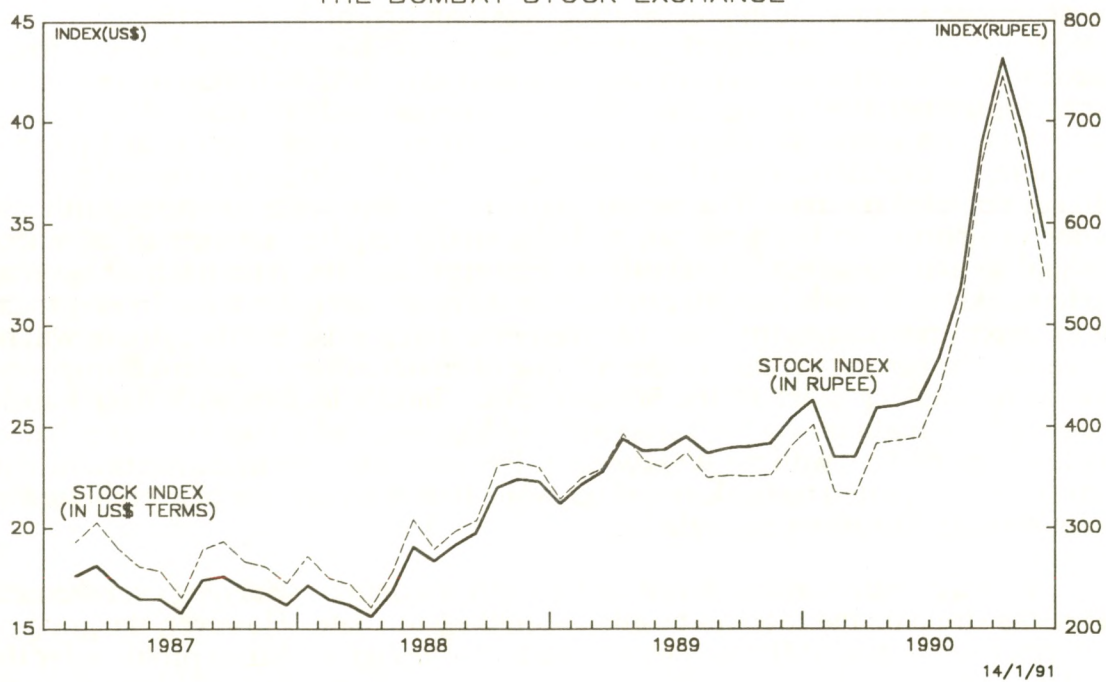
Allowing for the inflationary impact of the large monetised budget deficit, India's inflation record has been good (Chart 4) thanks to prudent monetary management. However, inflationary pressures have been recently building and the CPI has surged from just over 4% at the end of 1989 to over 8% while the WPI has risen to almost 10%. Some of these increases can be attributed to the acceleration of money growth at the end of 1988 but the main cause of the most recent jump has been India's vulnerability to the oil price rise. The country is potentially self sufficient in oil production but poor infrastructure and production methods, a failure to exploit its abundant reserves of natural gas, plus the location of one third of its supplies in its troubled northeast, means that India has to import 24 million tonnes per annum to meet its 58 million tonnes requirement. It is estimated that each \$1 a barrel rise in the oil price costs India an extra \$250 million per annum which puts an added strain on the already perilously low foreign exchange reserves. The government has already raised domestic oil prices and embarked on a strict energy saving campaign but the pressure is being felt in the form of higher inflation and a worsening current account deficit.

The other main factor contributing to higher inflation is the problem of production bottlenecks and capacity constraints. Domestic demand has been booming and industrial production growth, although volatile, has averaged 9% per annum in recent years (Chart 11) as a result of economic liberalisation and three successive good monsoons. Agriculture still accounts for 35% of GNP and another season of favourable rains could see India looking to export significant quantities of wheat, rice, sugar and cotton, although it must be said that the country is overdue a drought. The vibrant domestic economy has produced corporate profit growth rates of 30-50% over 1990 which is reflected in the performance of the Indian stockmarket (Chart 12). Share prices as measured by the Bombay Stock Exchange Index almost doubled from January to November 1990 before falling back due to fears of political instability. The market was one of the few not to react adversely to Iraq's invasion of Kuwait. However, despite a raging bull market and significant productivity gains, capital investment has not kept pace and many of the huge state run enterprises have outdated, inefficient production processes and poor, bureaucratised management. This has resulted in severe shortfalls in steel output, for example, and many other key inputs for the manufacturing sector which naturally leads to rising factory gate prices. Production growth has started to fall and is only expected to rise by around 6% this year. This will be reflected in lower profit growth during 1991 although this should still be a healthy 10-20%, and the market does not look expensive trading on 12-14 times prospective earnings. However, while political uncertainties and inflationary problems abound, there is little likelihood of a significant rally. The signal could be the election of a new government with a clearer mandate.

INDIA: CHART 11
INDUSTRIAL PRODUCTION



INDIA: CHART 12
THE BOMBAY STOCK EXCHANGE

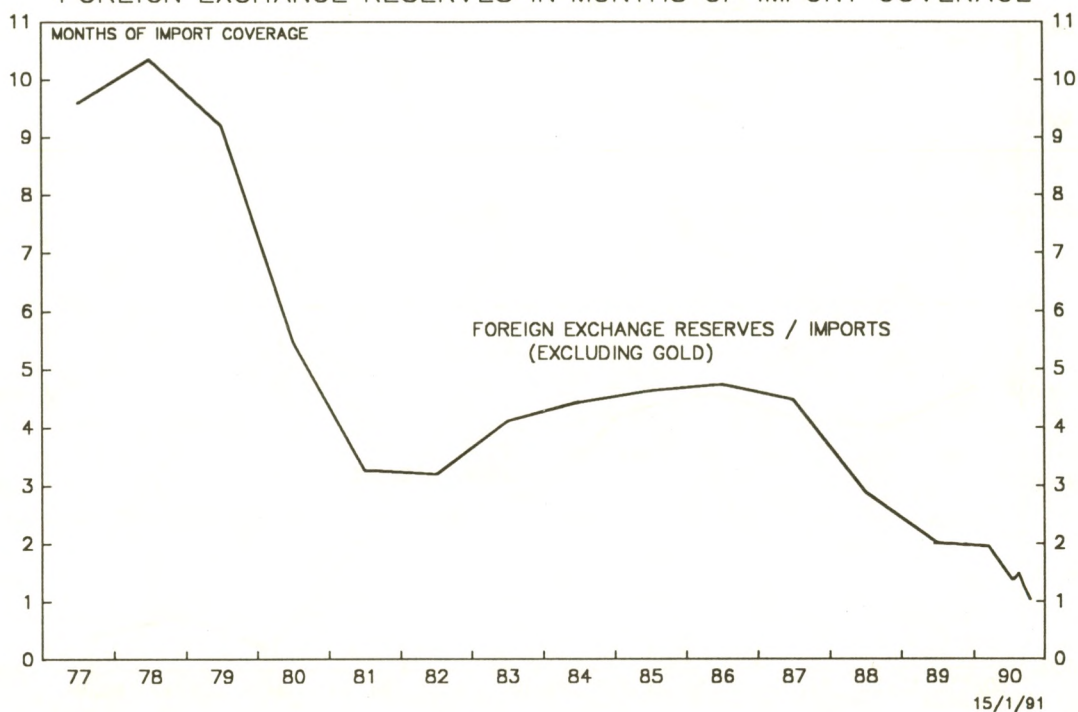


While internal problems are mounting, external problems have reached a critical level. India's foreign exchange reserves are at a dangerously low level (Chart 13) and at one stage fell to around only three weeks' import cover. A revaluation of gold reserves eased the situation but it has worsened again following the outbreak of the Gulf crisis. A temporary flood of remittances from 185,000 displaced Indians in the Gulf will boost reserves, but this is at the cost of the loss of the \$2 billion annual flow. The government has reacted by imposing a ban on all non-essential imports and embarking on an export drive. It has also raised excise duties and taxes, and offered further incentives to encourage non-resident Indians (NRIs) to repatriate foreign exchange. NRIs are offered preferential rates on US\$ deposits but there is a suspicion that much of the money in these accounts does not belong to Indians. They are also allowed to take up to 5% stakes in listed companies and the rules governing foreign direct investment (FDI) by NRIs are less stringent than those for other foreign investors. Nevertheless, NRIs have been slow to respond. Many of their investments tend to go into the blackmarket, or are for short term gain and are subsequently taken out of the country.

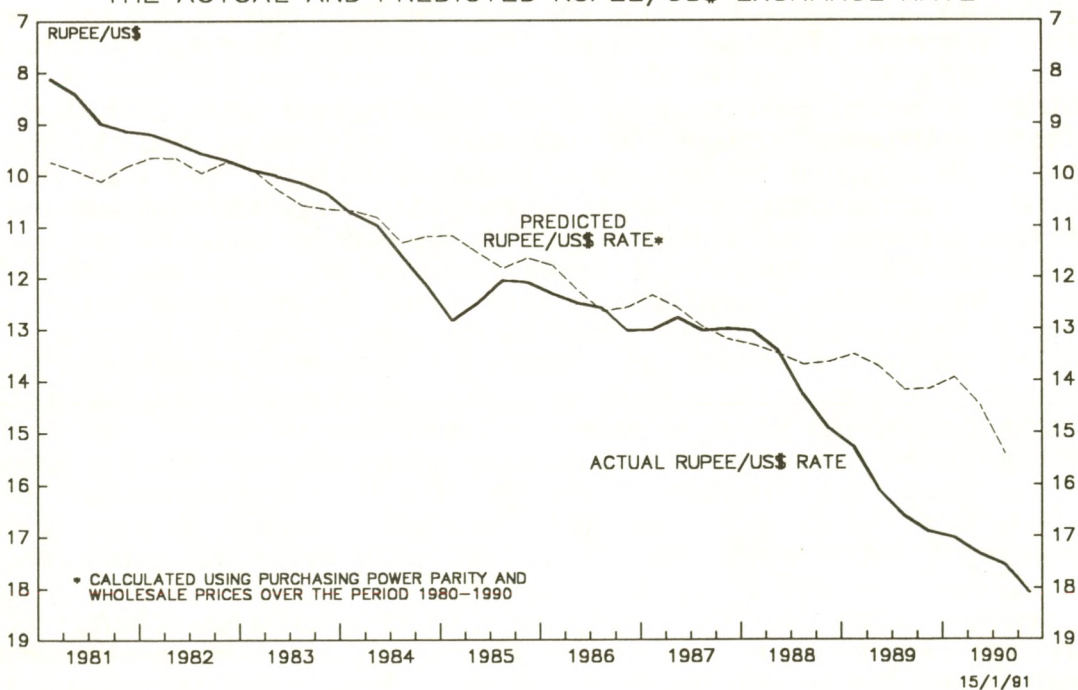
With no quick solution to the foreign exchange crunch in sight, the government has applied to the IMF for assistance. It has already been granted \$400 million in the form of a Compensatory Contingency Financial Facility, and just recently \$1.78 billion from the Extended Structural Adjustment Scheme. However, these loans may only be sufficient to tide India over its present difficulties and options have been kept open on whether to apply for a further \$2 billion. Any future loans will almost certainly come with IMF conditions attached such as the trimming of the budget deficit and the easing of restrictions on imports and FDI, but a devaluation of the rupee should not be included. The currency has been steadily depreciating and if anything is already undervalued against a currently weak dollar using a purchasing power parity basis (Chart 14). The rupee is not freely convertible but the RBI decides on the weights to be given to a basket of currencies comprising of the \$, DM, Pd., Yen and SFC. Furthermore, exports and imports are both less than 10% of GNP and therefore, have little effect on the overall growth path of the economy. Nevertheless, India's current account deficit is widening rapidly and expanded 35% to \$2.44 billion for the period April-September 1990, compared to the same period in 1989 (Chart 15). Capital inflows are no longer sufficient to cover the current account deficit and there is therefore, an overall balance of payments deficit that has to be met by draining the already depleted reserves. The current account probably needs to worsen further in order to improve in the long run as India vitally requires imports of advanced technology and capital equipment to boost export production. India has been opening up its market to imports and prior to the recent import clampdown was freeing many of its import restrictions for what it termed essential goods. Further strains will be placed on the current account by the collapse of communism in Eastern Europe and the changes taking place in the Soviet Union. India's leaders with their Fabian leanings have traditionally been close allies of Moscow, and a huge amount of barter trade was carried out with the Warsaw pact. Payment is now being demanded in hard currency for imported technology and oil, while Indian exports are being replaced by their Western European equivalents.

With a current account deficit that is likely to continue widening over the near term, the strain on the reserves position is unlikely to abate. However, the granting of further substantial IMF loans will alleviate the foreign exchange problem for the next few years. Whether the IMF will propose conditions that will lead to India

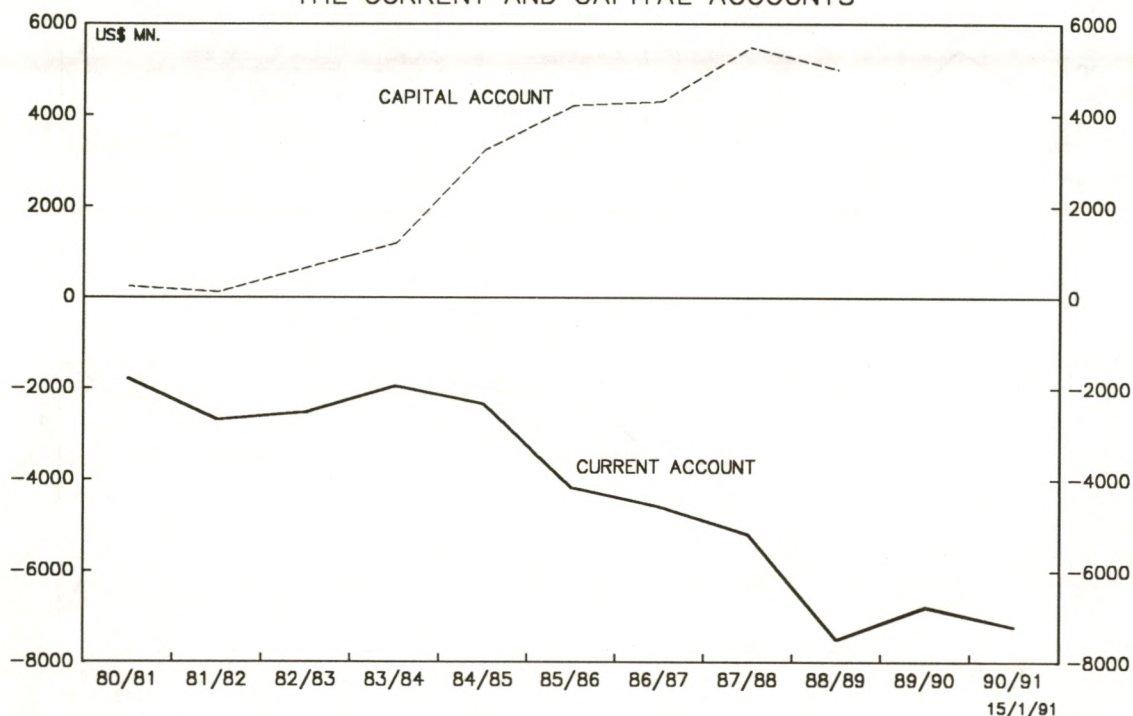
INDIA: CHART 13
FOREIGN EXCHANGE RESERVES IN MONTHS OF IMPORT COVERAGE



INDIA: CHART 14
THE ACTUAL AND PREDICTED RUPEE/US\$ EXCHANGE RATE



INDIA: CHART 15
THE CURRENT AND CAPITAL ACCOUNTS



trimming its budget deficit, or opening up its markets to FDI and direct equity investment is debatable. In fact the granting of the loan could give the government the excuse to delay further reform for a while longer.

SUMMARY AND CONCLUSION: The long term arguments for FDI and stock-market investment in India are still in place. The country has a huge resilient domestic market, high quality, cheap skilled labour, a savings ratio of over 20%, potential self-sufficiency in natural resources and good accounting and legal standards with English as the natural business language. The stockmarket is well developed and is becoming more strictly regulated, although insider trading is still legal! IMF loans should alleviate the current foreign exchange problems but the longer term problems of the twin deficits remain. Add to this rising inflation, a poor infrastructure and capital stock, domestic unrest, and political ineptitude and paralysis, and the outlook for 1991 does not look positive. Nevertheless, the path towards liberalisation and reform has been taken and although the pace may slow this year, it cannot be reversed. The election of a government with a clear mandate is imperative but whichever party ultimately governs may be largely irrelevant as they all offer similar manifestos. The emerging post independence generation of Indian leaders is inclined to be less fearful of foreign involvement in the economy, and measures are being introduced to increase FDI from the paltry \$150 million of 1990. However, direct stockmarket investment seems further off as the authorities claim to be following the Korean model of only opening up the market very gradually. Hindu philosophy teaches that if one is reborn it is because of sins committed in a previous life. This encourages people to accept their misfortunes and not to try to change their circumstances for fear of being reborn once more. Only recently have Indians been given a real chance to improve their living standards and they are still unsure of how to act. Reform and liberalisation will therefore only continue at a very Indian pace.

MALAYSIA

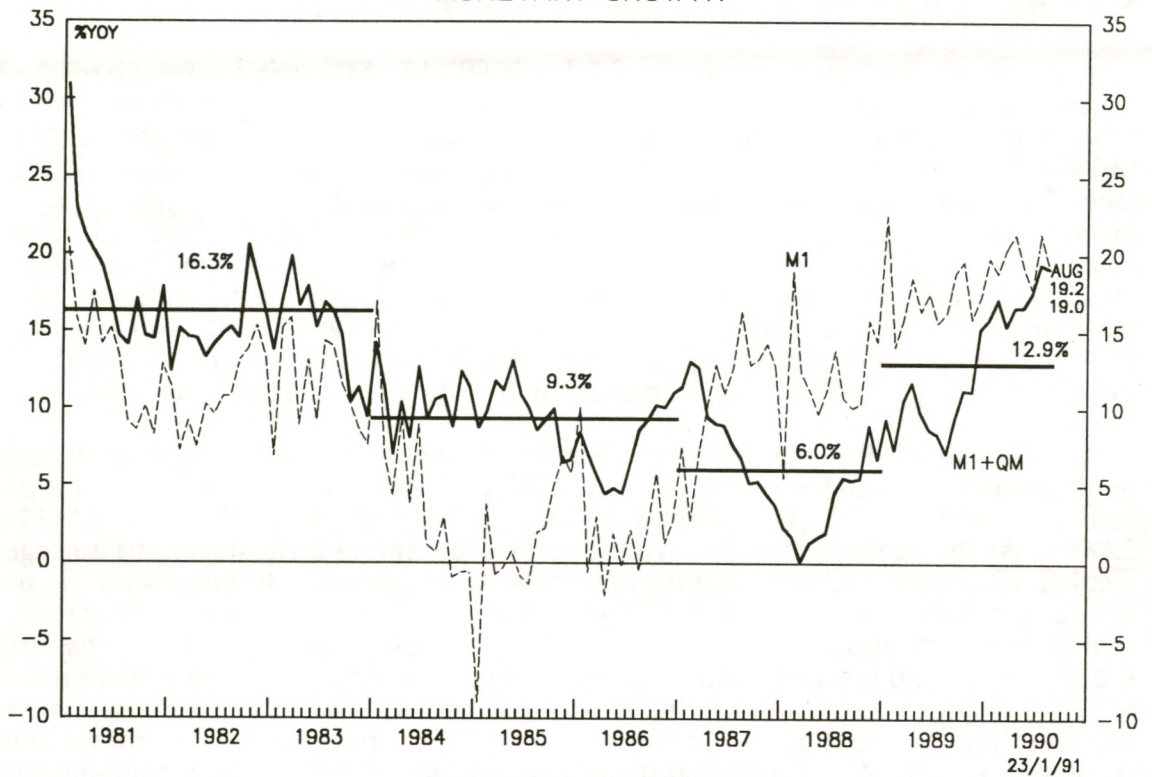
WHERE DID MONETARY POLICY GO WRONG?

Until mid 1989 the Bank Negara Malaysia (BNM), Malaysia's central bank had followed an exemplary policy with respect to monetary growth. M1 growth had, by and large, remained below 15% since 1981, while M2 had decelerated from around 25% in 1979-80 to 16.3% in 1981-83, 9.3% in 1984-86, and as low as 6% between 1987-88 (see Charts 1 and 2). As a consequence inflation was brought down from 4.5% in the period 1982-84 to less than 1% in 1985-87. Reflecting the low rate of inflation, interest rates were also at very low levels until late 1988. Economic growth, which recovered steadily through 1986 and 1987 following the recession of 1985, continued at a vigorous rate. Malaysia recorded a growth rate of 8.1% in 1988 and 8.8% in 1989. On the external side there was a surge in export growth during 1987 which continued well into 1988, and the trade balance remained in healthy surplus until early 1990.

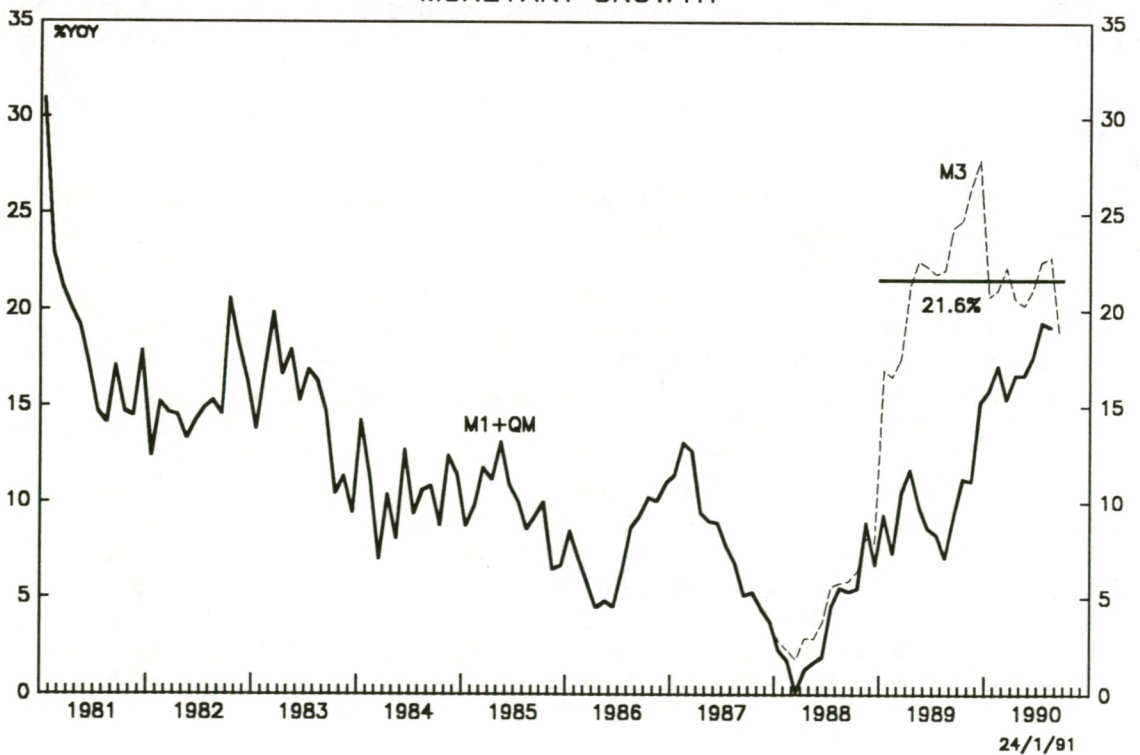
Since mid 1989 however things have started to go wrong. Monetary growth rates as measured by M1, M1 plus quasi-money or M2, and M3 have all accelerated sharply so that by August 1990 M1 was up by 19.2% year-on-year, M2 by 19.0%, and M3 by 22.8%. At the same time, other symptoms of overheating have started to emerge. Real GNP shown in Chart 3 continues to grow at a high rate, estimated at 9.6% for 1990 and officially forecast to be 8.1% for 1991. Chart 4 shows how from 1988 onwards real GNP growth has been supported by strong domestic demand while net exports (i.e. the goods and services account in real terms) have made negative contributions to GNP. Underlying this shift in the composition of the GNP, the trade and current accounts have been deteriorating sharply, with the trade balance shifting from a peak surplus of around M\$ 1.4 billion at the end of 1987 to a deficit in the second quarter of 1990 (see Chart 5). The extent of the overheating can be roughly judged by the widening of the gap between import growth and export growth shown in Chart 6. Note from Charts 5 and 6 that the downturn in the trade balance steepened significantly in 1989, and that this resulted primarily from a rise in import growth, not a decline in export growth. This increase in domestic absorption is *prima facie* evidence of overheating.

The question considered by this article is why monetary growth has been allowed to accelerate in this way over the past two years. In order for the money supply to grow or to accelerate it is necessary for the monetary base to grow or accelerate by a similar magnitude, assuming no changes in reserve requirements and no significant changes in the composition of the public's holdings of money (i.e. their choice between deposits and currency). Since the assets of the central bank corresponding to the monetary base can be divided into just two elements, namely foreign assets and domestic assets (i.e. BNM claims on the public sector or private sector), it follows that the increase in the monetary base which generated the acceleration in monetary growth can be analysed as deriving from either an increase in foreign assets or an increase in the central bank's holdings of domestic securities, or some combination of the two. In the former case, the reason why foreign assets would have increased is that the foreign exchange rate for the Malaysian Ringgit was being held down at too low a level relative to the US dollar and other currencies. As a result BNM would have been obliged to purchase foreign currency in the foreign exchange market, crediting the Malaysian banks from whom it was buying these assets with equivalent amounts of Malaysian currency. These newly created Malaysian Ringgits would have fuelled lending by

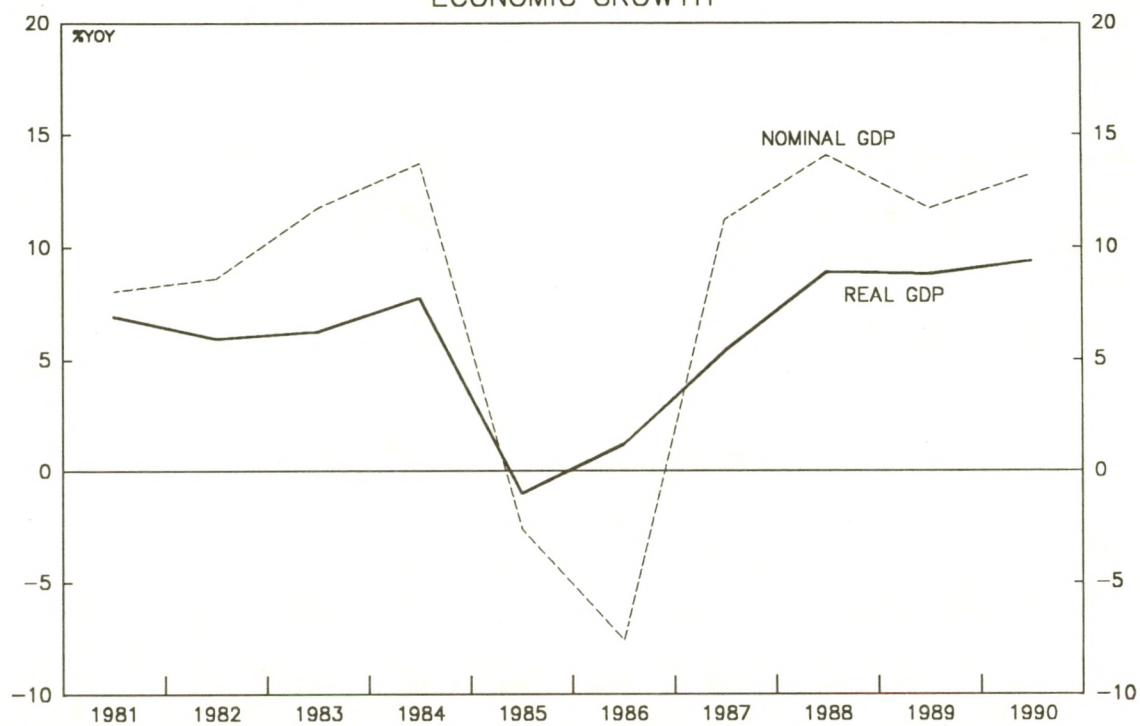
MALAYSIA: CHART 1
MONETARY GROWTH



MALAYSIA: CHART 2
MONETARY GROWTH

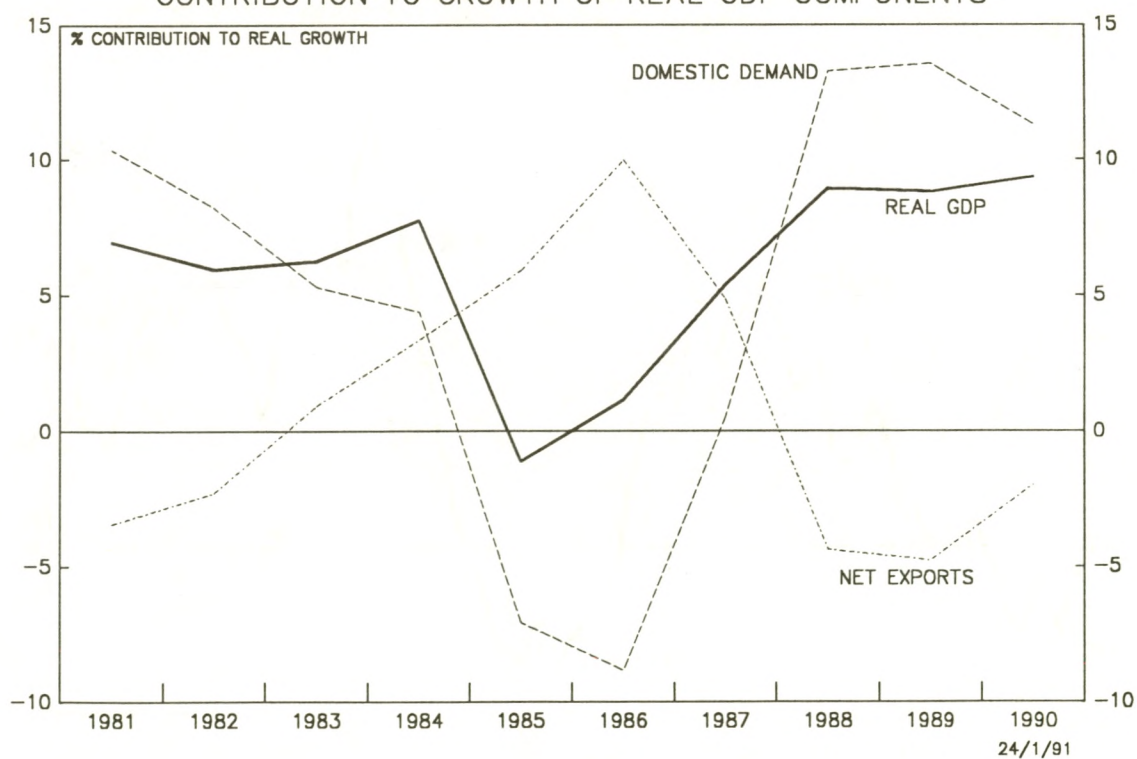


MALAYSIA: CHART 3
ECONOMIC GROWTH



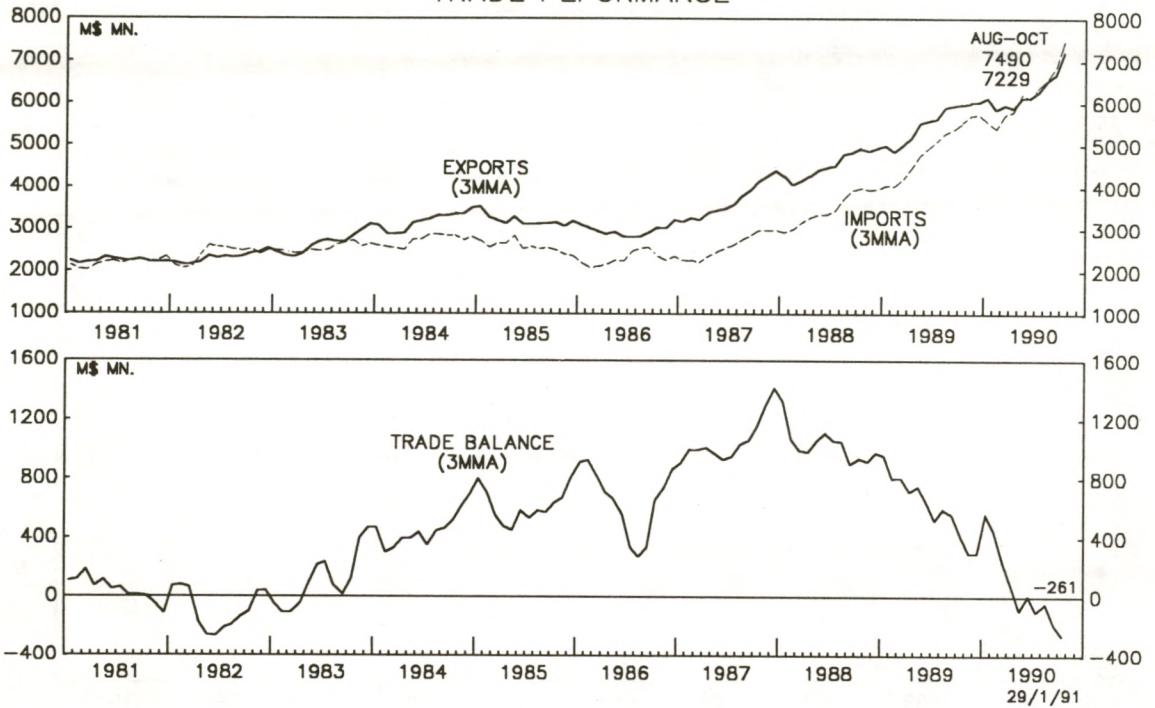
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MALAYSIA: CHART 4
CONTRIBUTION TO GROWTH OF REAL GDP COMPONENTS

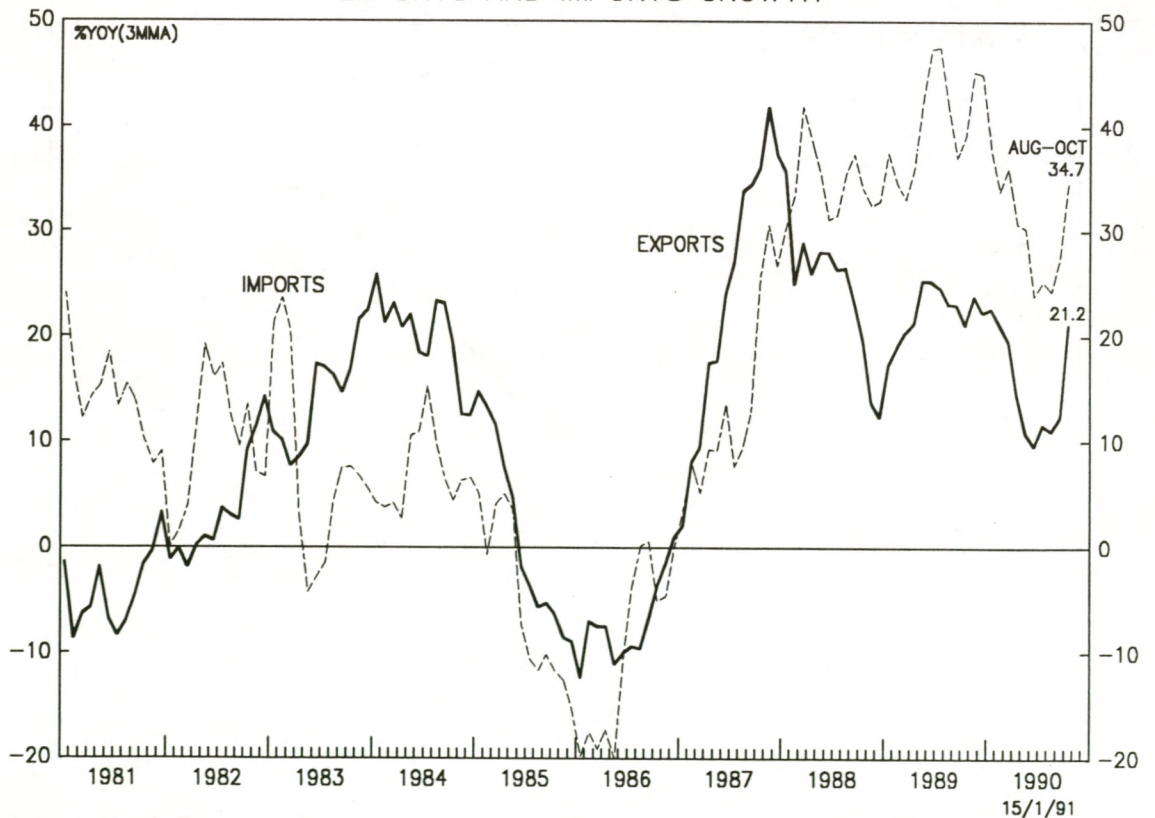


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MALAYSIA: CHART 5
TRADE PERFORMANCE



MALAYSIA: CHART 6
EXPORTS AND IMPORTS GROWTH



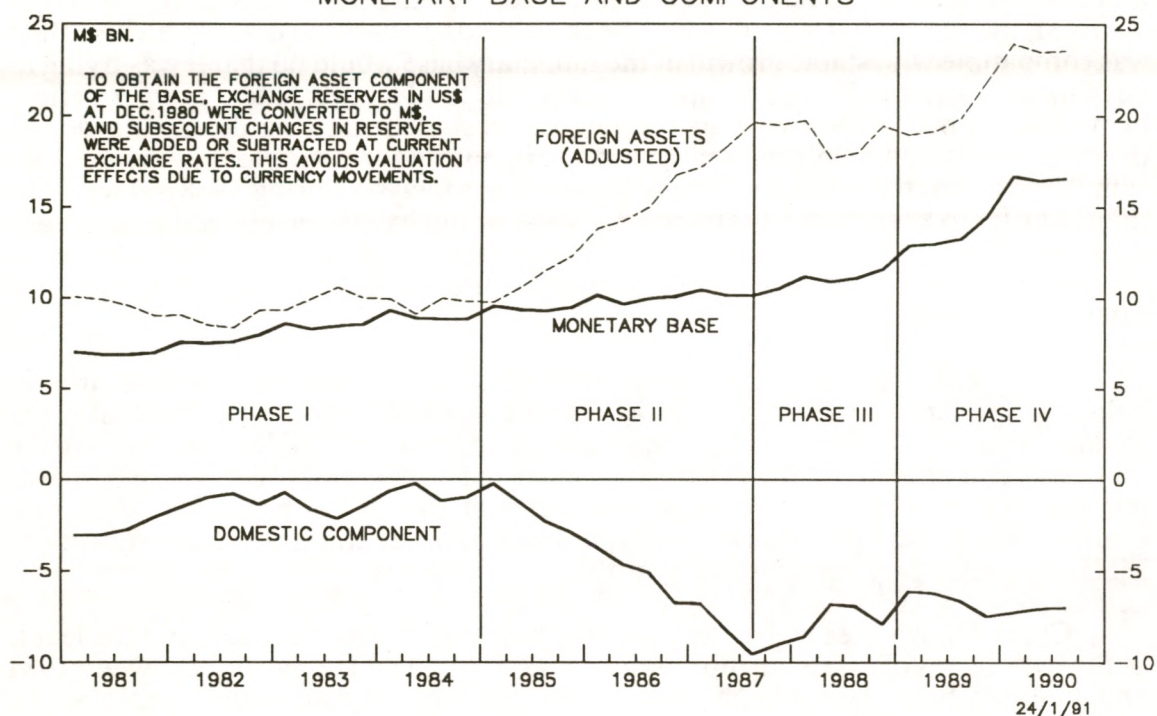
Malaysia's banks, which in turn would have been reflected in the acceleration of monetary growth. With respect to the latter, i.e. the purchase of domestic securities by BNM, the reason BNM would have been obliged to purchase more securities than was compatible with stable growth of the monetary base would be that it was trying to keep interest rates too low, perhaps in an effort to fund a government budget deficit, or perhaps simply with a view to keeping the cost of borrowing down in order to promote investment and economic growth. Supposing for example that the equilibrium level of interest rates for 12% M2 growth in Malaysia during 1988/89 was 7%, then in order to keep interest rates at 6%, BNM would have been obliged to purchase an increasing amount of Treasury bills or private sector securities, or make an increasing amount of direct loans to the banks in order to keep money market interest rates down at 6%.

In short, the sources of the increase in the monetary base can be divided into two policy components: either the foreign assets component of the base was increasing too rapidly because the exchange rate was being held at an artificially low level, or the domestic component of the base was increasing too rapidly because BNM was pursuing a policy of maintaining interest rates at too low a level. We shall now examine the evidence for these two hypotheses in order to pinpoint the sources of Malaysia's monetary acceleration over the past two years.

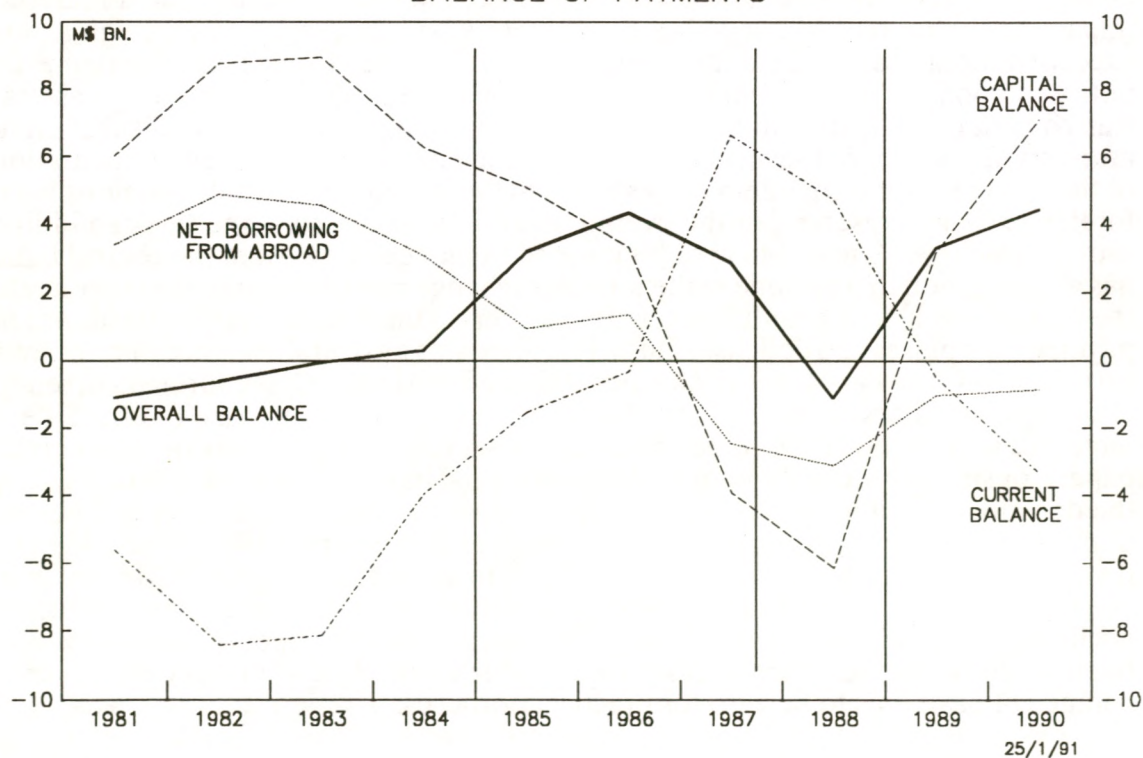
Chart 7 shows the level of the monetary base over the past decade, and the levels of the two classes of assets corresponding to it -- foreign and domestic. Between 1981 and 1990 the base (i.e. currency plus reserve deposits of commercial banks at the BNM) grew from M\$7 billion to M\$ 17 billion, but it is clear from Chart 7 that most of the growth has occurred since the beginning of 1989. (It is true there have been changes in reserve requirements over this period, but these have not had a material impact on the ratio of M2 or M3 to the monetary base.) The BNM's foreign assets exceeded the size of the base throughout the past decade. Conversely, the domestic policy component (which is obtained as the residual of the base less the foreign assets) was consistently negative in an arithmetic sense, though the BNM held substantial amounts of government securities throughout the decade. The pattern of fluctuation of the foreign asset component corresponds to the additions to or subtractions from foreign exchange reserves, or the overall balance of payments -- the thick solid line shown in Chart 8. Under Malaysia's managed exchange rate system the central bank has an obligation to intervene in the foreign exchange market to keep the currency at the desired level. In accounting terms, these interventions result in overall balance of payments surpluses and deficits. Thus when there was an overall balance of payments surplus, as in the years 1985-87 and 1989-90, the BNM was buying foreign currency, creating new Malaysian Ringgit, and therefore causing the base to rise. To offset these increases in the base BNM could sell domestic securities (e.g. T-Bills or commercial paper), or simply reduce its loans to the commercial banks. This is what is implied by the decline in the domestic component of the base in 1985-87 and again in 1989-90. Similarly, when foreign reserves were declining, as in the period 1987 Q3 to 1989 Q1, it was necessary for BNM to add to its portfolio of domestic securities in order to counteract the decline in foreign exchange reserves, and thus prevent the base from declining. The only way to avoid these continuous offsetting operations would have been to allow the currency to float freely, which would have allowed the overall balance of payments to be zero for practical purposes.

To analyse BNM's policy over the past decade, Chart 7 can be usefully divided into four phases: 1981-84, 1985-87 Q3, 1987 Q3-1988, and 1989-90. The different

MALAYSIA: CHART 7
MONETARY BASE AND COMPONENTS



MALAYSIA: CHART 8
BALANCE OF PAYMENTS



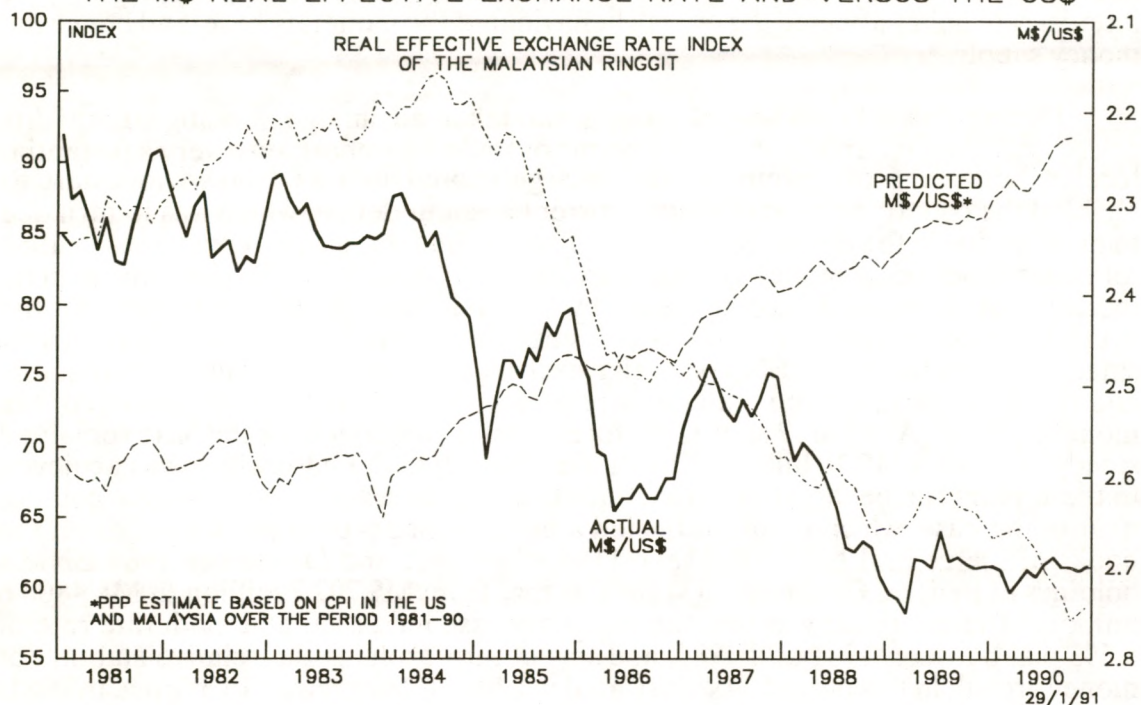
policy mix during each of these phases will be described in turn, showing how developments in the balance of payments, exchange rate policy, fiscal policy or interest rate policy affected the overall behaviour of the monetary base, and hence the money supply.

During Phase I (1981-84), Malaysia had taken advantage of rising commodity prices and the favourable shift in its terms of trade to embark on a very substantial foreign borrowing programme. These large capital inflows (shown in Chart 8) enabled the country to finance a huge current account deficit, which was in turn due to overheating in the domestic economy. The CPI had increased at over 10% in 1981 following a period of money growth in excess of 20% in 1979-80. The approximate matching of the current account deficit by capital inflows in 1981-84 meant that the overall balance of payments deficits and surpluses shown in Chart 8 were relatively small. In other words the BNM's foreign exchange reserves remained roughly stable and therefore there was no material foreign asset contribution to the growth of the monetary base. As Chart 7 shows, the foreign asset component of the base remained steady at around M\$ 10 billion. The modest growth of the base which was achieved in these years can be largely attributed to the trend increase in the domestic component of the base, which in turn reflected a build-up of government securities on the books of the central bank. Between December 1981 and December 1984 BNM's holdings of Federal Government securities rose from M\$ 707.7 million to M\$ 4808.6 million. The net result was that the monetary base increased at a moderate rate of 8.6% p.a. between 1981 and 1984, and this in turn explains the relative stability of money growth in this period. As illustrated in Chart 1, M2 grew at 16.3% p.a. in 1981-83, and then slowed to 9.3% p.a. in 1984. It was this monetary deceleration and relative stability at a low rate of growth which laid the groundwork for the decline in Malaysia's inflation from an average of 4.5% p.a. in 1982-84 to below 1% in 1985-87.

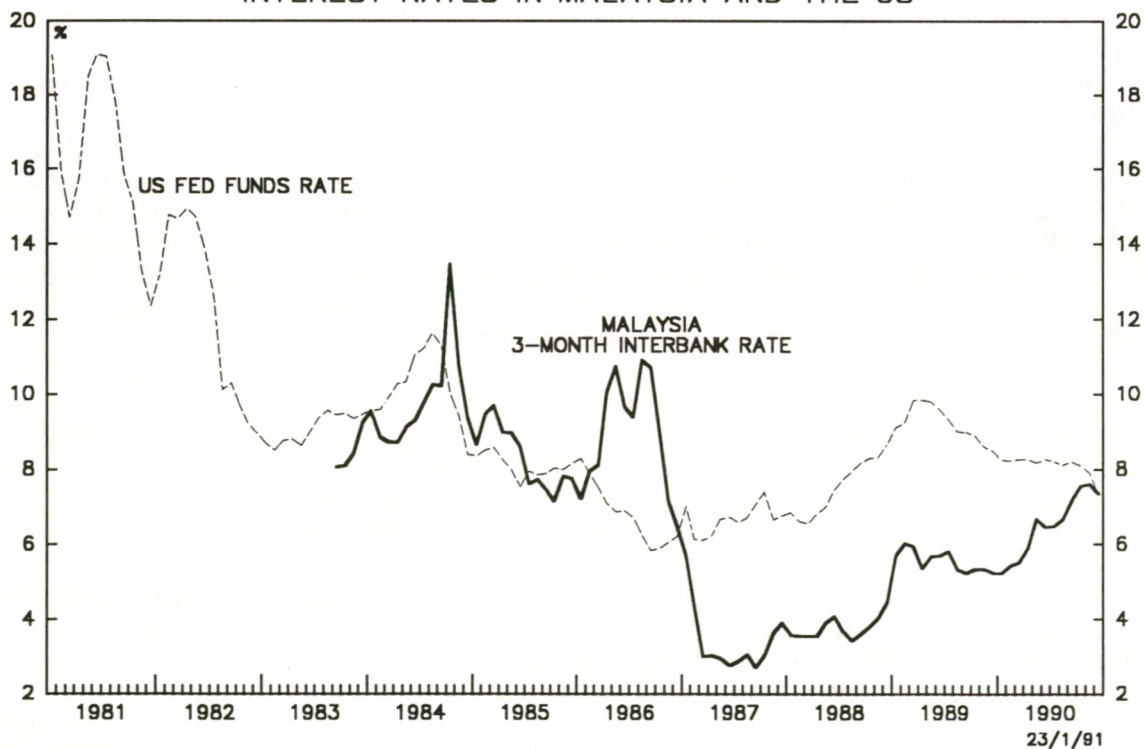
In Phase II between 1985 and 1987 there were several major changes in the structure of Malaysia's balance of payments brought about developments both at home and abroad. The 1985 recession was instrumental in cutting back imports and improving the trade balance, while the current account recovered from deficit to surplus by 1987 (Chart 8). The switch from current account deficit to surplus partly reflected the clamps which had been placed on domestic demand due to the slowness of money growth in the years preceding, as well as the very sharp recovery in exports from 1987 onwards, which in turn was assisted by the depreciation in the currency since 1984. Another change in the balance of payments was the reduction in net foreign borrowings from an average of M\$ 4.0 billion p.a. in 1981-84 to an average of only M\$1.1 billion p.a. in 1985-86, and a switch to net repayments in 1987. The end result shown in Chart 8 was the emergence of overall balance of payments surpluses of M\$3-4 billion, with the result that the foreign assets of the BNM rose steeply. In 1985-87 the growth of these foreign assets was successfully sterilised by reductions in BNM's holdings of government securities (from M\$ 4808 million at the end of 1984 to M\$ 1961 million at the end of 1987), and consequently monetary base growth again remained both stable and relatively low (4.6% p.a.) for the whole period.

It was during these years (1985-87) that a fundamental shift in currency and interest rate policy occurred. Between 1979 and 1984 Malaysian's viewed their country as being endowed with a wide range of natural resources which would ensure a healthy external trade position, and permit the authorities to run a strong currency policy. The real effective exchange rate appreciated until late 1984, and the Ringgit fluctuated in a 6-7 cent range on either side of M\$ 2.30 per US dollar. However once

MALAYSIA: CHART 9
THE M\$ REAL EFFECTIVE EXCHANGE RATE AND VERSUS THE US\$



MALAYSIA: CHART 10
INTEREST RATES IN MALAYSIA AND THE US

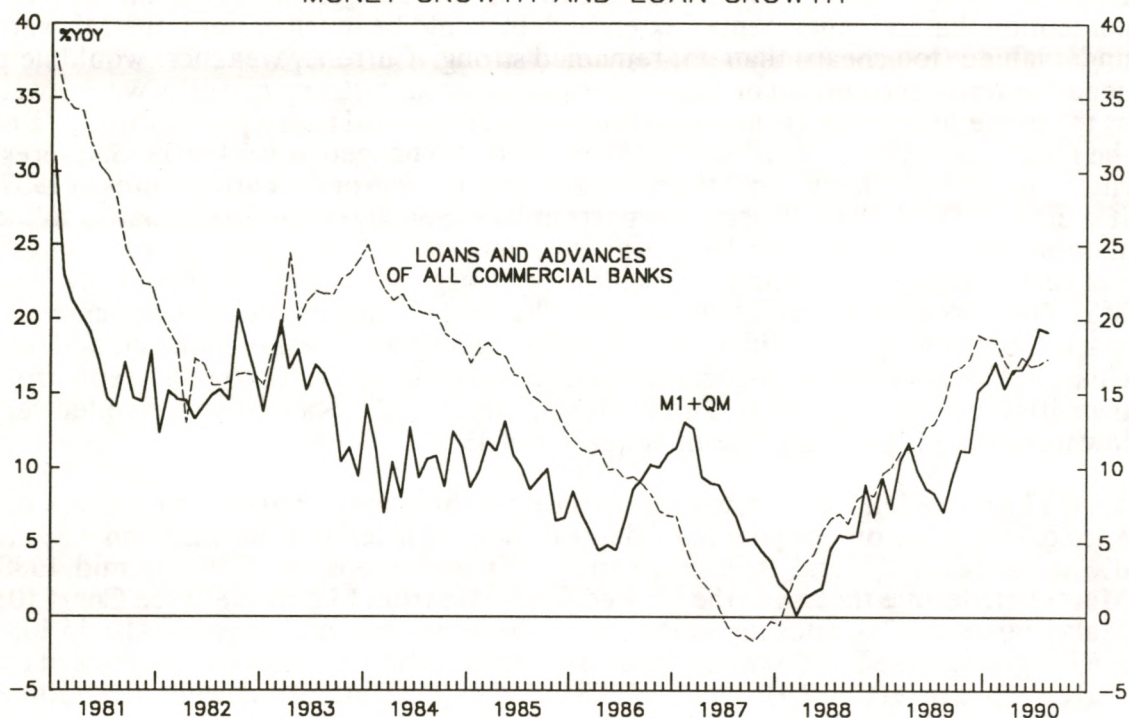


the US currency began its big appreciation in 1984-85, the Ringgit was allowed to slide. It seems likely that an important motive for the Ringgit depreciation was the perception that the repayment of external debt would be much easier if the M\$ were undervalued (too cheap) than if it remained strong. Currency weakness would help generate trade and current account surpluses, whereas a strong currency was viewed as the immediate cause of the export slump in 1985-86 and thus a proximate cause of the recession of 1985. Whereas the currency policy changed in 1984 or 1985, interest rate policy did not change until the closing months of 1986 or the early months of 1987. It seems that with the recovery in exports in late 1986 and early 1987 (thanks to the slide in the US dollar), the Malaysian currency started to show signs of strength. Between December 1986 and April 1987 the Ringgit recovered quite abruptly from M\$ 2.60-65 to M\$ 2.48 per US dollar (see Chart 9). Taking its cue from the currency market, but perhaps also with an eye on the prevailing weakness of loan demand (see Chart 11), the central bank encouraged interbank interest rates to fall steeply from over 10% in September 1986 to under 3% by March 1987. Rates then remained very low from March 1987 until the final quarter of 1988.

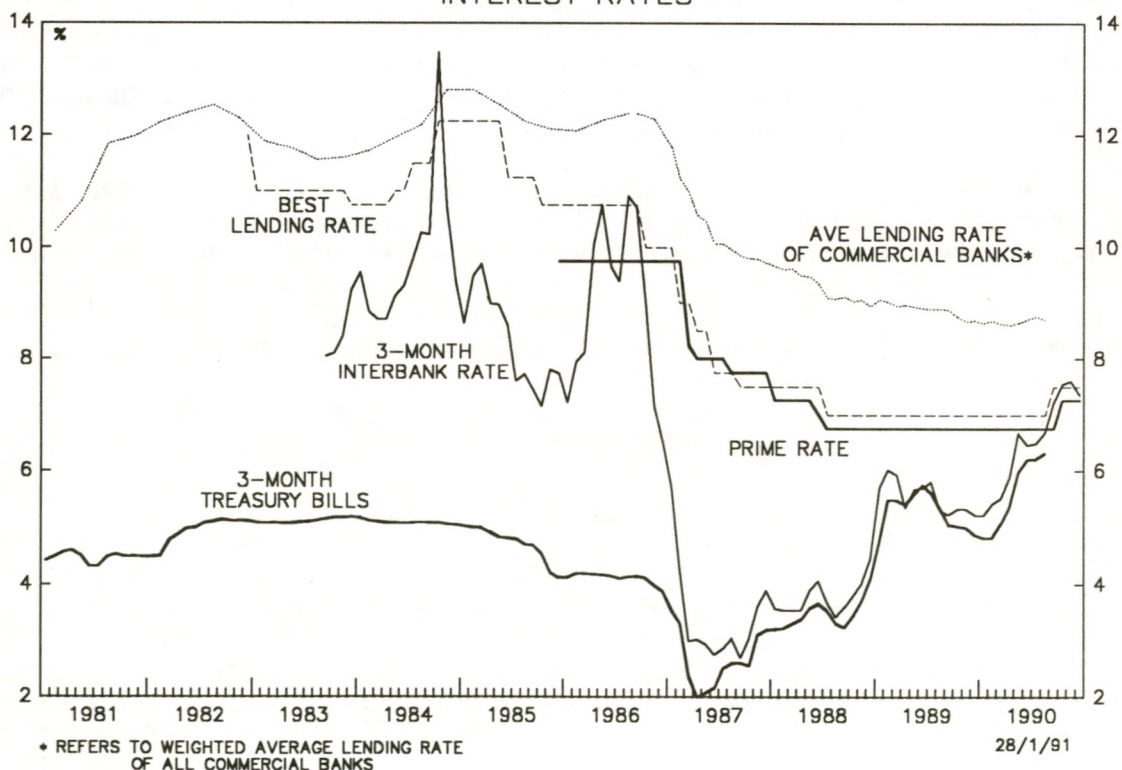
The prime lending rate, which lags the interbank rate, in part due to the dependence of the banks on one year fixed deposits, was adjusted downwards from 9.5% to 8% in March 1987, and then in a series of smaller steps to 6.75% by mid 1988. Moreover, despite the rise in the US Fed funds rate from March 1988 (see Chart 10), Malaysian interbank rates remained below 4% for the rest of that year. Also in 1988 the Ringgit resumed its downward slide both against the US dollar and in terms of the real effective rate (Chart 9). Thus by 1988 the Malaysian authorities were maintaining a weak currency and low interest rates. Chart 9 shows a purchasing power parity estimate of the "correct" level of the Malaysian currency against the US dollar, based on consumer prices in Malaysia and the USA. Even allowing for the bias in the composition of these two indices of "non-tradeables", the estimate suggests the Ringgit was substantially undervalued (15%) by the end of 1988. An earlier AMM article (July-August 1989) explained how this weak currency, low interest rate policy mix was fundamentally incompatible with monetary stability in the long run. In Phases III and IV we see how the contradiction was resolved.

By 1987-88 (Phase III) the weak currency policy had started to bear fruit. Large current account surpluses emerged in these two years (Chart 8), enabling the government to repay \$2.55 billion of debt in 1987, and \$4.76 billion in 1988 so that the official or public sector component of the long term capital account switched from inflows or surpluses of M\$ 2.1 billion in 1985 and M\$ 2.4 billion in 1986 to outflows or deficits of M\$ 2.47 billion in 1987 and M\$ 5.1 billion in 1988. At the same time private capital outflows, generated by concerns about currency weakness, added to the overall capital outflow with the result that the overall balance of payments slipped from M\$ 4.7 billion in 1984 to a surplus of M\$ 2.89 billion in 1987, and slumped to a deficit of M\$ 1.1 billion in 1988. The foreign asset component of the monetary base therefore peaked out in late 1987 and declined during 1988. On the domestic side BNM was able to compensate for this downturn by adding to its securities. For example, in some rather unusual transactions -- also commented on in an earlier issue of AMM (July-August 1989) -- BNM purchased shares in Malaysian International Shipping Corp. (MISC) and Malaysian Airline System (MAS) from the Federal Government which used the proceeds to prepay foreign debt. While BNM's holdings of government securities did not change very much, "other assets" rose from M\$ 2.7 billion at the end of 1987 to M\$ 5.9 billion at the end of 1988. For the BNM this was a change in the

MALAYSIA1: CHART 11
MONEY GROWTH AND LOAN GROWTH



MALAYSIA: CHART 12
INTEREST RATES



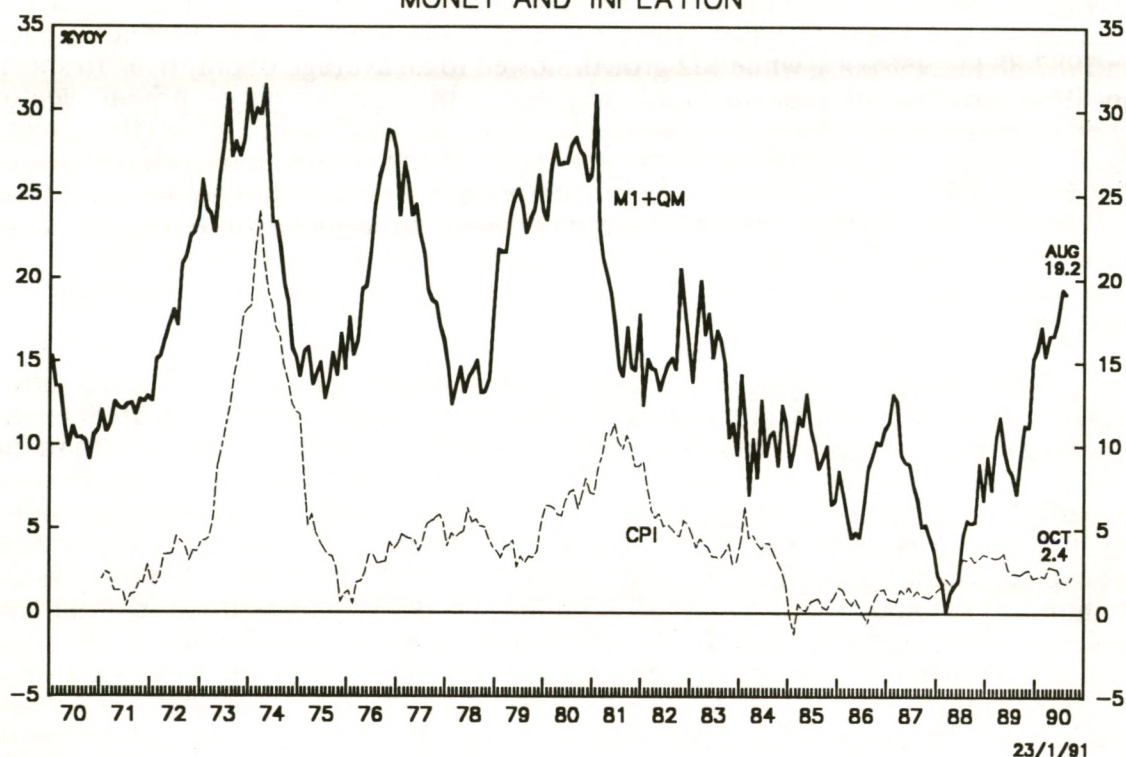
composition of its assets; for Malaysia as a whole there was an overall balance of payments deficit which had to be counteracted to prevent a contraction in the monetary base. The net result was that the monetary base again grew at a healthy pace in 1987-88 (12.9% p.a.), while M2 growth slowed to an average of only 6%. In short, in 1988 government repayment of overseas debt together with private sector speculative outflows (due to the low interest rates) were sufficient to offset the current account surplus (due to the weak currency policy), and create an overall balance of payments deficit and hold down the monetary base. If either private sector capital inflows were to resume or the government were to suspend or reduce its debt repayment plans, BNM might not find it so easy to hold back the growth of the monetary base without sacrificing either its weak currency policy or the low interest rate policy.

In fact this is exactly what happened in 1989-90 during Phase IV. Chart 8 shows how the current account shifted to deficit in 1989 and a larger deficit in 1990 as the growing momentum of Malaysia's growth absorbed more goods and services than the country sold to the rest of the world. At the same time net private capital inflows -- especially for direct investment -- soared from M\$ 1.8 billion in 1988 to M\$ 5.0 billion in 1989 and an estimated M\$ 8.3 billion in 1990. Meanwhile government repayment of overseas debt (an outflow) roughly halved from M\$ 5.1 billion in 1988 to M\$ 2.6 billion in 1989 and an estimated M\$ 2.3 billion in 1990. This resulted in a massive reversal of the capital account deficit of 1988 to surpluses of M\$ 2.3 billion in 1989 and M\$ 5.9 billion in 1990. The outcome for the overall balance of payments was a surplus of M\$3.3 billion in 1989 and M\$ 4.4 billion in 1990, and a corresponding increase for BNM's foreign assets. Unfortunately, instead of offsetting this huge increase in its balance sheet by reducing its domestic assets or other sterilisation measures, BNM only achieved token success: the domestic policy component remained roughly stable through 1989 and 1990. Consequently, the base grew by 22.1% between 1989 Q1 and 1990 Q3, and monetary growth has likewise soared. Based on data available to date M1 has averaged 18.3% p.a. in the past two years, M2 12.9% p.a. and M3 21.6% p.a.

How could BNM have avoided spoiling its exemplary record of the early and mid-1980s? From the argument presented above there were broadly two possibilities open to the authorities. First, they could have abandoned their cheap currency policy and appreciated the Ringgit upwards to reduce the overall balance of payments surplus, thus reducing the foreign asset contribution to the increase in the base. In fact, they appear to have ceased allowing the currency to depreciate against the US dollar and have been holding the Ringgit steady around M\$2.70 per US dollar. Nevertheless, this has not been enough to prevent the huge capital inflows from overwhelming the current account deficit.

The second possibility would have been to raise interest rates earlier, which would have curtailed lending and hence money growth. In fact BNM did show clear signs of anxiety about the situation in 1989. In January and February interbank rates were raised to almost 6%. With effect from May 1st, 1989 statutory reserve deposits were raised by 1% (from 3.5% to 4.5%), and in October by another 1% (to 5.5%). However in mid-year (1989) BNM was reported as refusing to allow commercial banks to raise their rates, and it was not until May 1990 that interbank rates returned to 6%. Aside from reducing commercial loan demand (which, as Chart 11 shows, started to grow very strongly in 1988, reaching double digit growth rates in 1989), a policy of higher interest rates would have enabled BNM to offset the balance of

MALAYSIA: CHART 13
MONEY AND INFLATION



payments surplus by either selling securities out of its own portfolio to absorb excess liquidity or creating new liabilities (such as Treasury Bills "B" issued by the Central Bank of China in Taiwan) for the same purpose. Even though interbank rates were allowed to rise in April-May 1990 and again in August-October, the BNM still refused to allow banks to raise their prime lending rate until September.

The conflict between the BNM's cheap currency, low interest policy and the quest for monetary stability has been the central issue of Malaysian monetary policy over the past two years. The refusal of the authorities, whether at the Ministry of Finance or at BNM, to raise interest rates while at the same time holding down the currency in the face of large overall balance of payments surpluses has undermined the record of successful monetary policy in the early and mid-1980s. As the economic boom induced by currency undervaluation and by rapid money growth has built up, so has the clamour for higher interest rates -- particularly from the banks whose margins were being squeezed by a rising interbank rate and an artificially pegged lending rate. On Friday, January 25th 1991 BNM finally gave way, announcing that it will surrender control of banks' base lending rates from February 1st 1991. Whether freeing up bank lending rates will be sufficient to enable BNM to re-assert control over monetary growth remains to be seen. There are still numerous controls on swaps and banks' foreign exchange positions, as well as restrictions on the operation of the forward currency markets which effectively inhibit the arbitrage between Malaysian money markets and overseas markets. The abandonment of lending rate controls should therefore be seen as just one step towards a more liberalised domestic credit market.

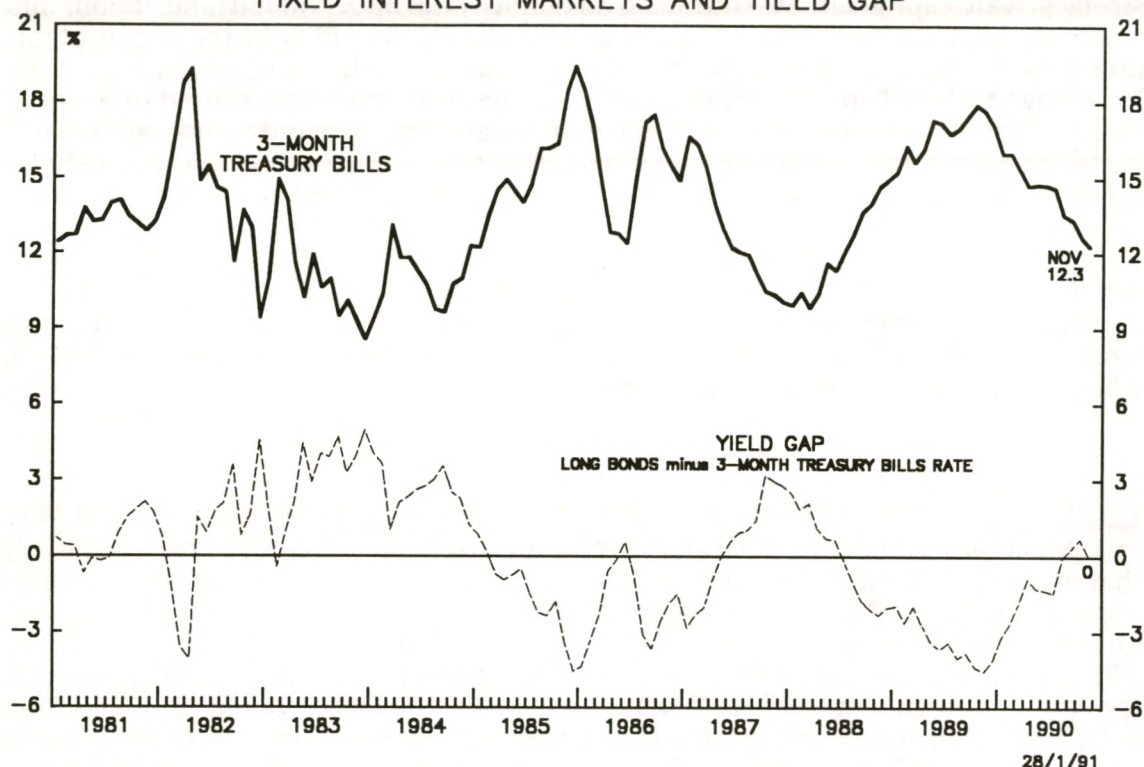
To conclude, the Malaysian monetary authorities have for several years pursued a cheap currency policy which has enabled the country to repay some of its foreign debt out of the surpluses generated from the resulting current account surplus and the strong private capital inflow -- attracted no doubt by the undervalued land, labour and raw material resources. While Malaysia was in recession in 1985-86 the effects of this policy did not adversely affect the operation of monetary policy. Initially as the export-led recovery picked up momentum in 1987-88, the current account shifted to substantial surpluses which were offset by large debt repayments to avoid an overall balance of payments surplus, and hence prevented growth of foreign assets at the BNM and upward pressure on the monetary base. Later, in 1989 and 1990, the switch to current account deficit was fortuitously offset by huge capital inflows. Unfortunately, at some point in 1988 or 1989 the authorities appear to have compounded the cheap currency problem by setting their face against interest rate increases, effectively tying not just one hand (currency policy) but both hands (currency and interest rates) behind their back. The end result has been a steep acceleration of money growth through 1989-90, which will require forceful action to restrain.

FORECAST: After two years of rapid monetary growth -- particularly M2 and M3 - the Malaysian authorities have at last acted to permit interest rates to rise. It is likely that interest rates will rise by at least two percentage points over the next few months -- giving a prime of 9.5% -- and it is probable that they will rise again later in the year. Other consequences of the two-year surge of money growth will also become evident. The current account deficit for 1991 will grow to perhaps M\$ 8-10 billion, far beyond the cautious official forecast of M\$ 4 billion set out in the December budget. Inflation will also start to accelerate, and the labour shortage, already apparent in some areas, will translate into further pressure for wage increases. Based on Chart 13, which shows the relationship between the growth of M2 and consumer prices in Malaysia, inflation could rise above 5% -- perhaps to 7% -- over the next year or so. In the stock market these forces will tend to undermine earnings estimates, while the higher interest rates will exert downward pressure on PE ratios. To prevent an interest rate crunch, the authorities could consider moving the exchange rate upwards, as the Singaporean authorities have done over the past two years, and liberalising other restrictions on capital movements. Raising the exchange rate when the current account is already in deficit may seem like a strange proposal, but it should be remembered that Malaysia's "problem" is the huge capital inflow and the impact of this on the monetary base and hence on the money supply. This course of action will only be viable assuming capital inflows remain strong. If they do not, then it is hard to see how Malaysia can avoid some sort of credit crunch.

For the past three or four years Malaysia has been able to pursue unorthodox mix of monetary policy measures, the consequences of which remained out of the spotlight. As the contradictions between the cheap currency, low interest policy and monetary stability have emerged into the open, the authorities are being obliged to take more action to resolve those contradictions. For the next few months while interest rates are adjusting upwards to a new and appropriate equilibrium level, credit and hence money could continue to grow rapidly, especially as the economy is growing so strongly. Malaysia therefore has many months, possibly as much as a year, of overheating still ahead.

AUSTRALIA: CONTINUOUS EASING OF MONETARY POLICY

AUSTRALIA: CHART 1
FIXED INTEREST MARKETS AND YIELD GAP

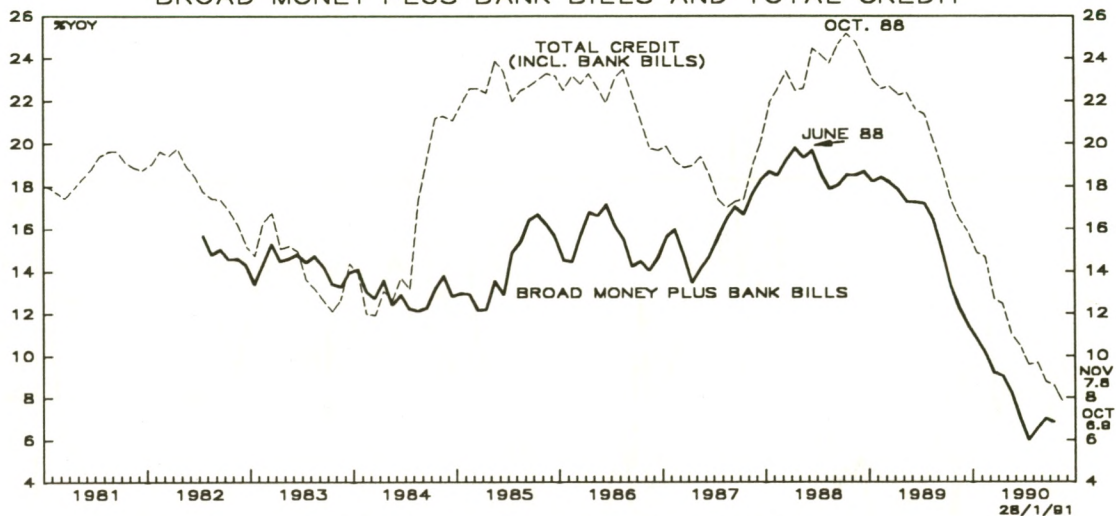


On December 18th the Reserve Bank of Australia announced the sixth drop in interest rates during 1990. This makes it a grand total of 600 basis points fall in cash rates from 18% at the start of the year to 12% at the end.

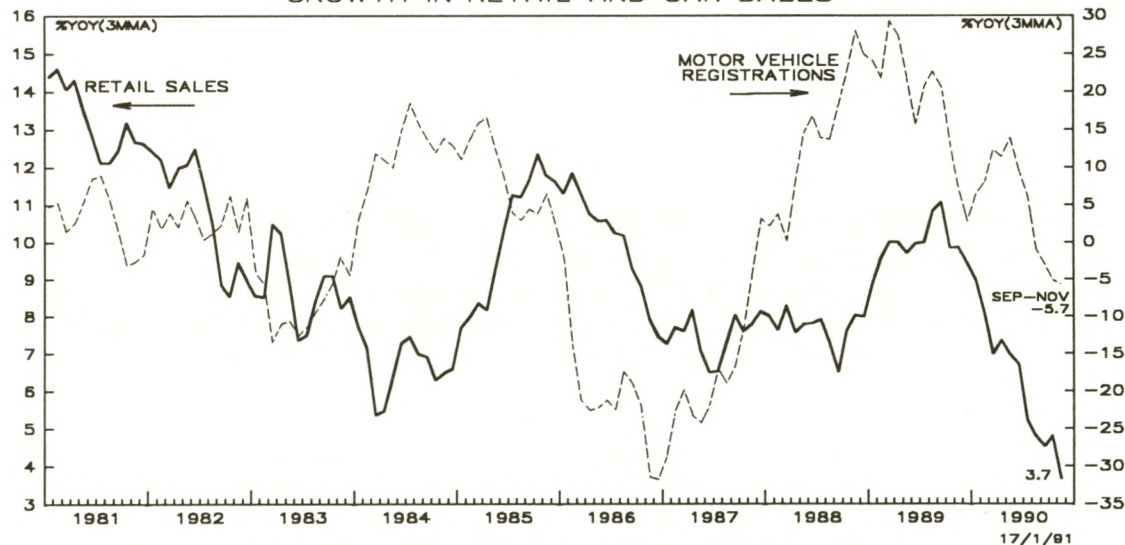
The yield curve turned positive in September (although it has recently become flat), another indicator of monetary ease (Chart 1). The economy, however, has not yet given unequivocal signs that it has troughed. There has been no clear upturn in monetary growth (Chart 2 upper panel). The November figures for the rate of growth of total credit extended by the banking system etc. showed a 7.8% yoy increase, down from October's equivalent figure of 8.6%. As the middle panel of Chart 2 shows both retail sales and motor vehicle registrations growth continued to decline. Unemployment in December stood at 8.1% compared to 5.9% in December last year.

A brighter sign, however, is the clear upturn in dwelling approvals. It is widely expected that the upswing in the Australian economy will be led by a recovery in the construction and housing sector. Despite the frequent reductions in interest rates during 1990 it may take another quarter or so before the effects of these falls make themselves felt. For the time being the equity market takes comfort from the fact that further reductions in interest rates are not precluded particularly if there are clearer signs that inflation is on a downward trend during 1991.

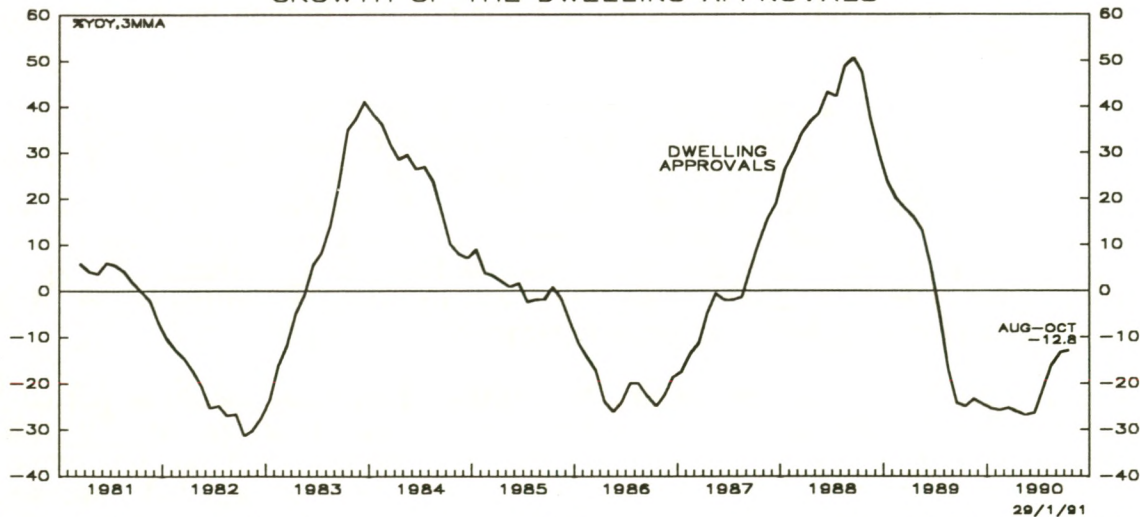
AUSTRALIA: CHART 2
BROAD MONEY PLUS BANK BILLS AND TOTAL CREDIT



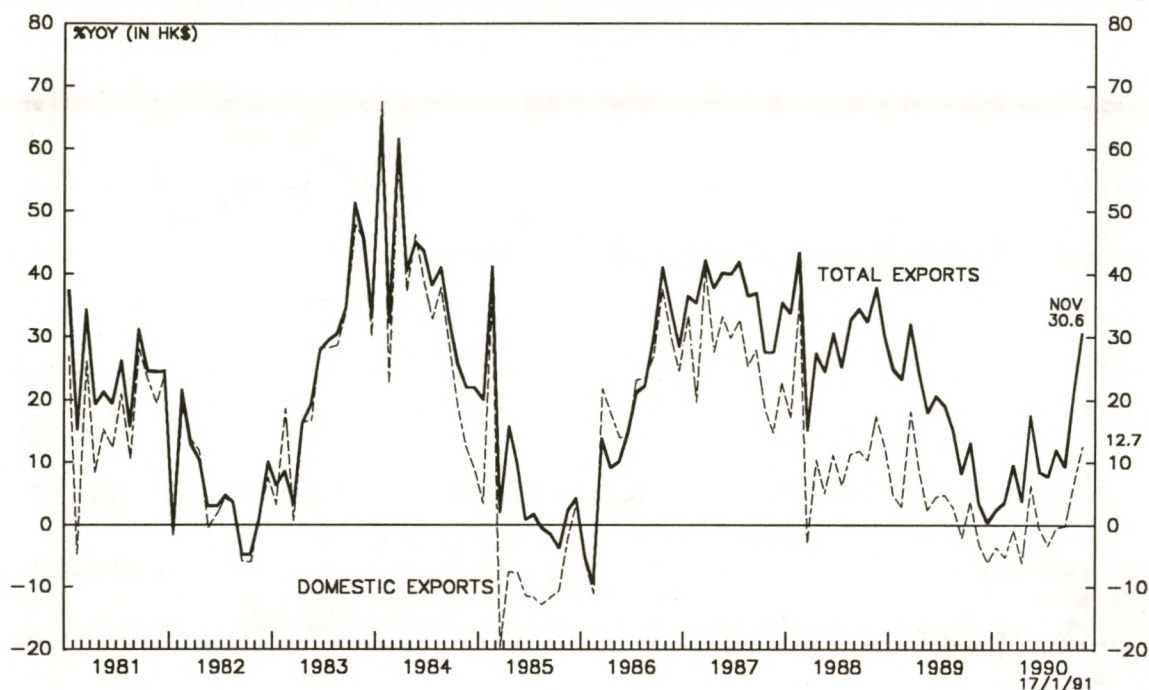
GROWTH IN RETAIL AND CAR SALES



GROWTH OF THE DWELLING APPROVALS



HONG KONG: THE REAL TRUTH BEHIND THE EXPORT FIGURES



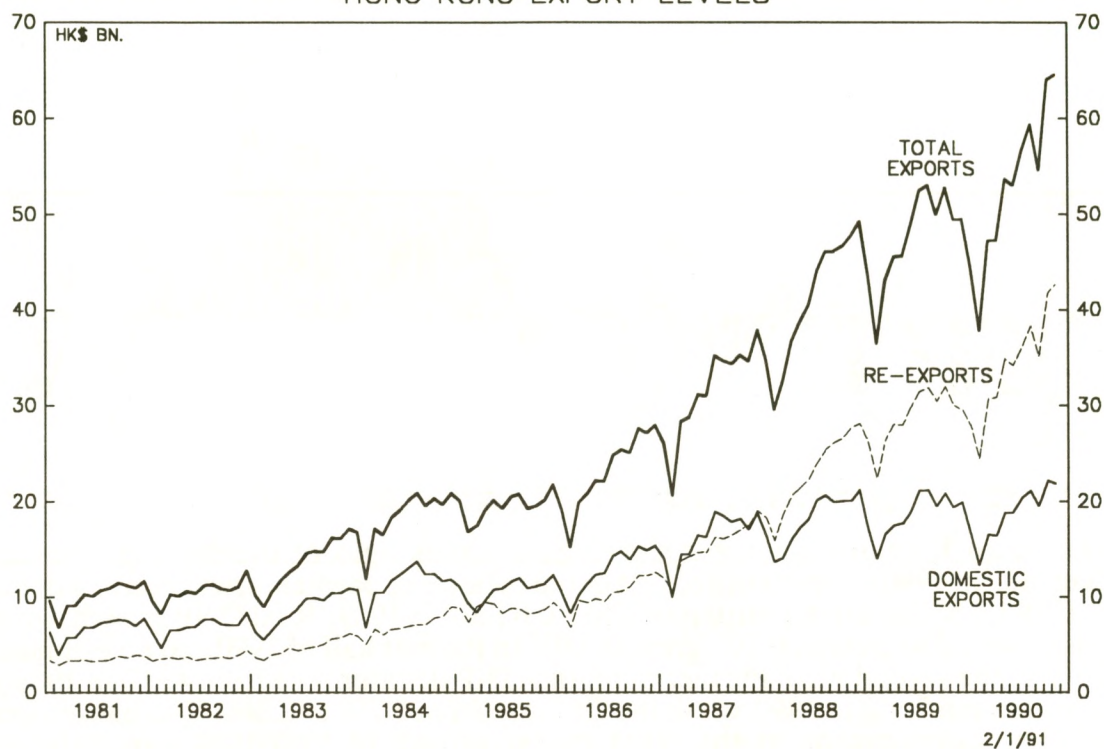
At first sight, Hong Kong's trade figures for November make good reading with domestic exports rising 12.7% year-on-year (6.4% October) and re-exports surging a massive 42.1% year-on-year (30.8% October). This translates into total export growth of 30.6% year-on-year (21.2% October) which indicates substantial strength in an economy where domestic exports alone count for over 40% of GDP, and re-exports count for another 70%.

However, a closer examination reveals that these year-on-year figures may well be magnified due to the low base effect of the slump in exports following the June 1989 Tiananmen Square massacre. Indeed the level of domestic exports is little higher than the peak level of 1989. Nevertheless, the news on the re-export front is encouraging and substantial real gains are being made as the recovery in the Chinese economy gains momentum.

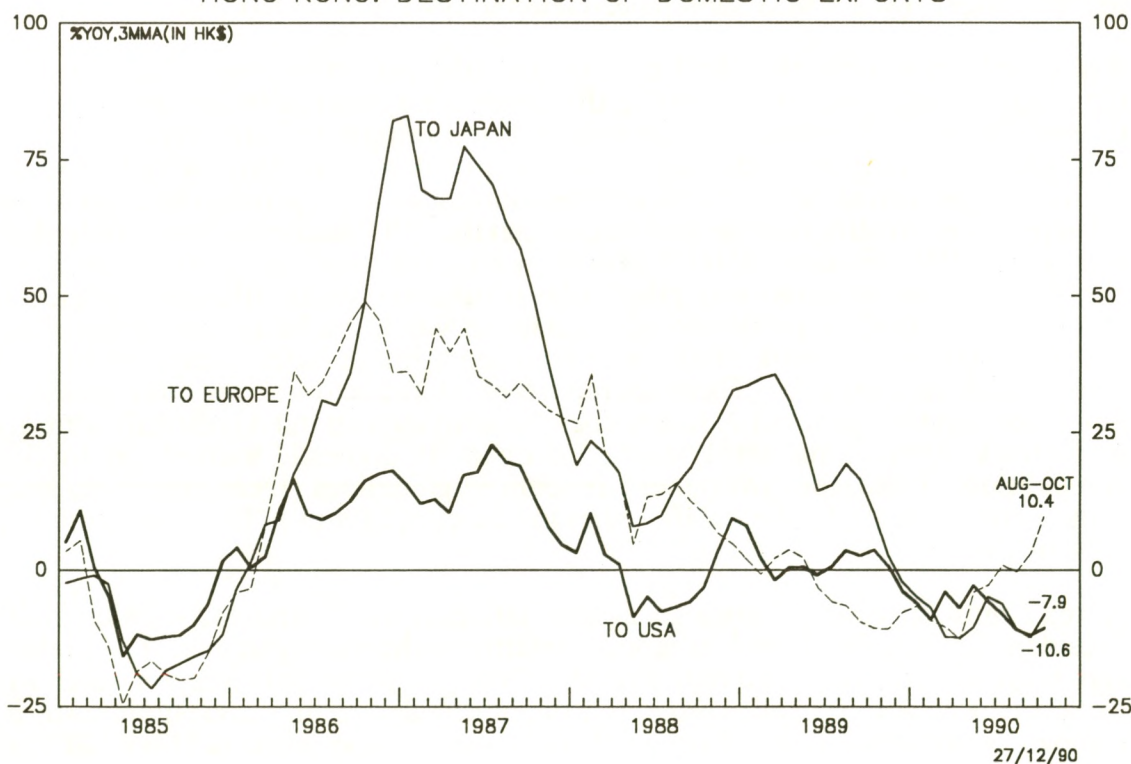
Does this then herald a significant recovery in the Hong Kong economy? The three major criteria for such a recovery are a strong Chinese economy, a weak US\$ and a stronger US economy. There are now clear signs of a recovery in China and the US\$ remains historically weak. However, there seems little chance of an upturn in the economy until at least the second half of 1991, and this will tend to restrict domestic export growth. Furthermore, economic growth in Hong Kong's other major export markets, Japan, Europe and the Asian region, will probably slow further in 1991, and thus demand for Hong Kong exports is likely to remain sluggish.

The recovery in the Chinese economy implies that Hong Kong should be partially insulated from the effects of the downturn in its other major export markets. The case for a sustained recovery in Hong Kong and thus Hong Kong stockmarket investment depends on the ability of China to sustain its recovery in the face of a global slowdown.

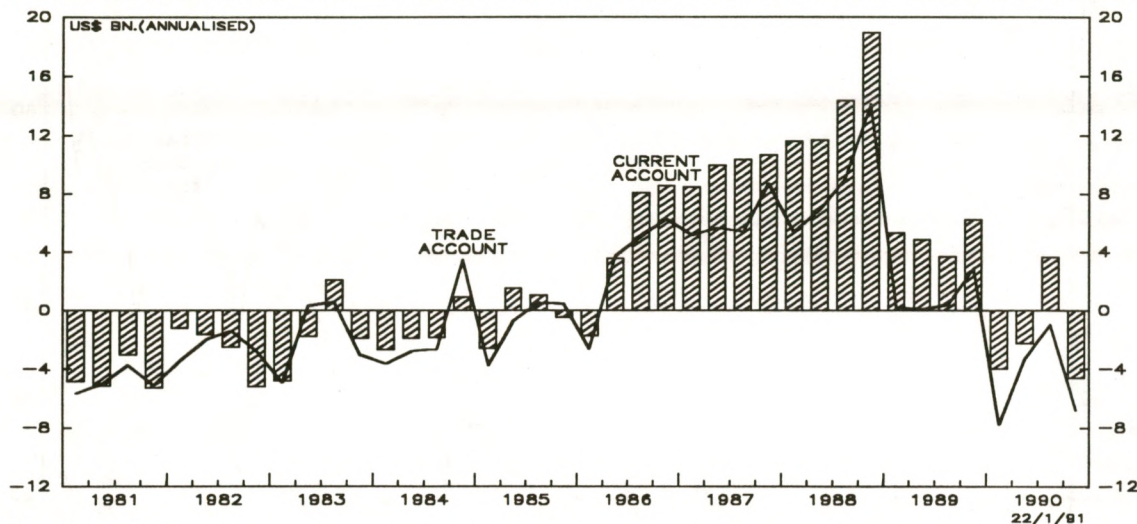
HONG KONG EXPORT LEVELS



HONG KONG: DESTINATION OF DOMESTIC EXPORTS



SOUTH KOREA: TREATING THE SYMPTOMS NOT THE CAUSES.

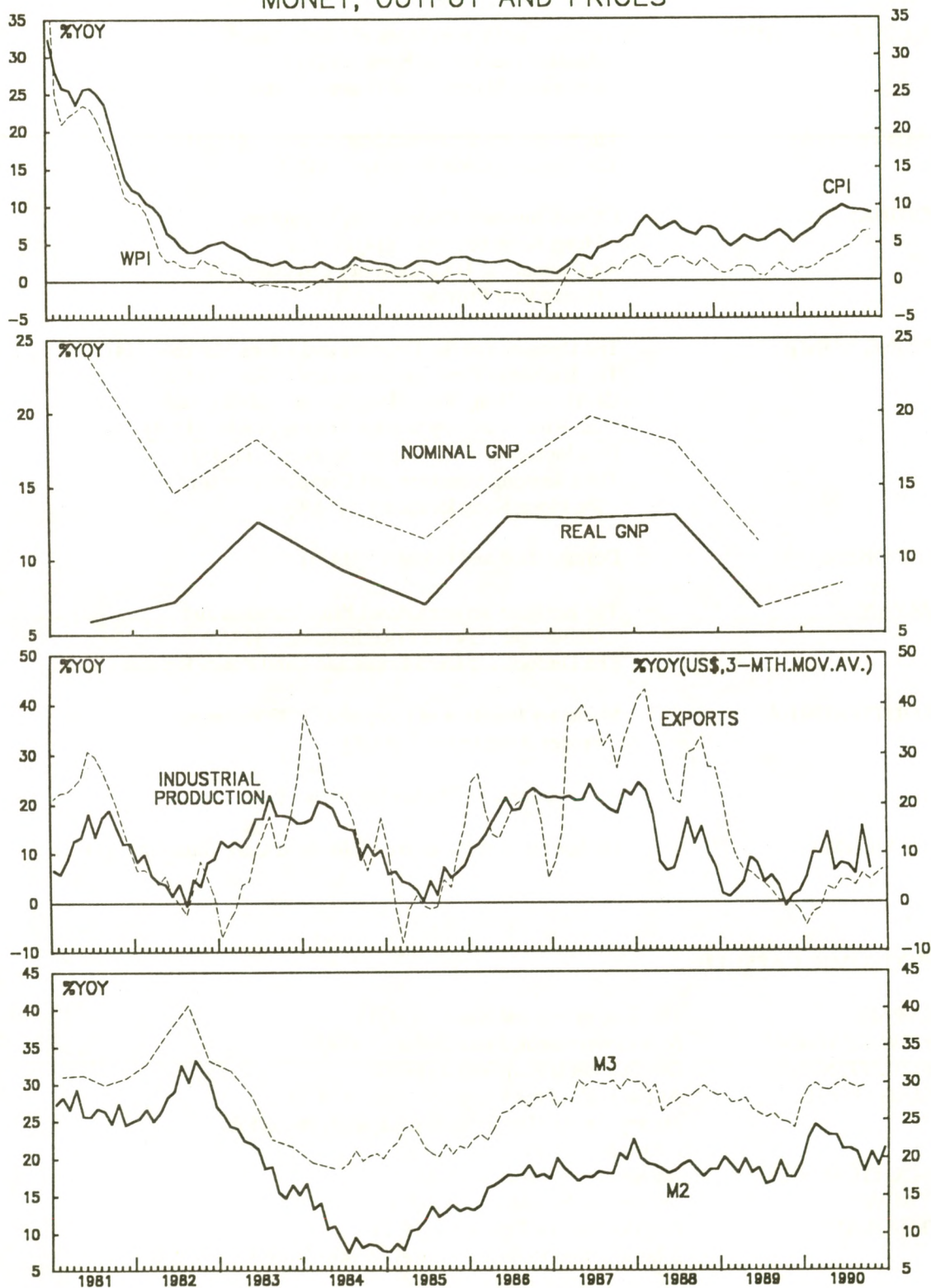


The South Korean economy is showing numerous signs of overheating or excess demand. In 1990 the current account of the balance of payments switched to a deficit of US\$ 1.8 billion after a surplus of US\$5.0 billion in 1989. Real GNP growth, which was expected to grow at 6-7%, grew at 9.9% in the first half of 1990 and an estimated 7.5% in the second half. Furthermore, the GNP deflator rose from 4.6% in 1989 to an estimated 7.5% in 1990, while the CPI rose from 5.7% to 8.8%. The background to these developments is the rapid money growth of 1987-1989, especially the monetary injection (to support the stock market) of December 1989 which pushed M2 up to 25% year-on-year, and the persistent rapid growth of M2 through 1990 (21.3% to December). (See AMM September-October 1990, Vol. 14 No. 5).

Regrettably, it appears that the Korean authorities are attempting to suppress the symptoms of inflation while avoiding the tough measures needed to deal with the causes of the excess demand. First, immediately following the oil price hikes of August and September the government imposed a freeze on domestic oil prices, and on public utility charges such as bus and railway fares, domestic air flight prices and water and gas supplies, expressing their determination that the CPI should not show double-digit increases in 1990. Since the start of 1991 these controls have been partially lifted, but since the best they can do is to alter the profile of inflation (not the ultimate price level) and delay appropriate economic adjustments, it would be better to abolish them anyway. Second, the authorities are conducting a broad-based campaign to limit conspicuous consumption. (There are reports of tax inspectors taking down details of new owners of foreign cars.) Not only does this curb imports but it is directly contrary to Korea's international undertakings to open its domestic markets to foreign competition. Third, the government announced guidelines (December 9) to keep wage increases in 1991 to below 10% after increases of 21% in 1989 and an estimated 17% in 1990.

Korea's most successful campaign against inflation was in the early 1980s under President Chun, using a single weapon -- control of the money supply. The present campaign will fail unless and until President Roh grasps the only weapon which will work. In the meantime explicit price controls, informal guidelines and public austerity campaigns notwithstanding, Korea will continue to experience near-double digit inflation.

THE REPUBLIC OF KOREA MONEY, OUTPUT AND PRICES



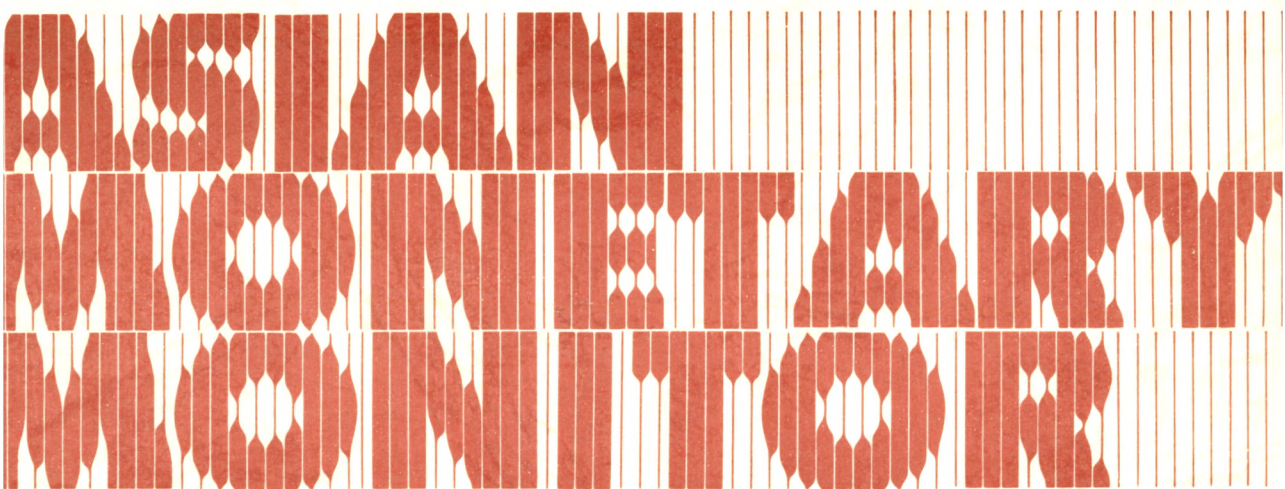
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March - April, 1991

Vol. 15 No.2

PEOPLE'S REPUBLIC OF CHINA UPDATE ON CHINA'S ECONOMIC REFORM: THE 7TH PLENUM.

The 7th Plenum of the 13th National Party Congress which was supposed to have met in September 1990, finally met December 25-30, concluding just one day before the 1986-90 5-Year Plan lapsed. Controversy over the content of the 8th 5-Year Plan (for 1991-95) had delayed the start of the meeting for three months, and caused the meeting to run for three days longer than scheduled. Differences among the hard-liners (headed by Prime Minister Li Peng) who favour a return to central planning, and the reformers (led by Li Ruihuan, and backed by provincial officials) led to a communiqué which was long on vague economic goals, and full of political rhetoric, compromise and even contradiction, but short on clear economic mechanisms for achieving those goals. On January 28th the Central Committee published its "Proposals for Formulating the 10-Year Programme (1991-2000)", and the "Eighth 5-Year Plan (1991-95) for Economic and Social Development" which had been endorsed by the 7th Plenum. To be implemented the various Proposals or Plans have to be approved by the National People's Congress to be held in late March. Normally, this is a rubber-stamping operation, but it is possible that the controversy will persist and emerge again at the NPC meeting. The following is a round-up of issues addressed in the three documents.

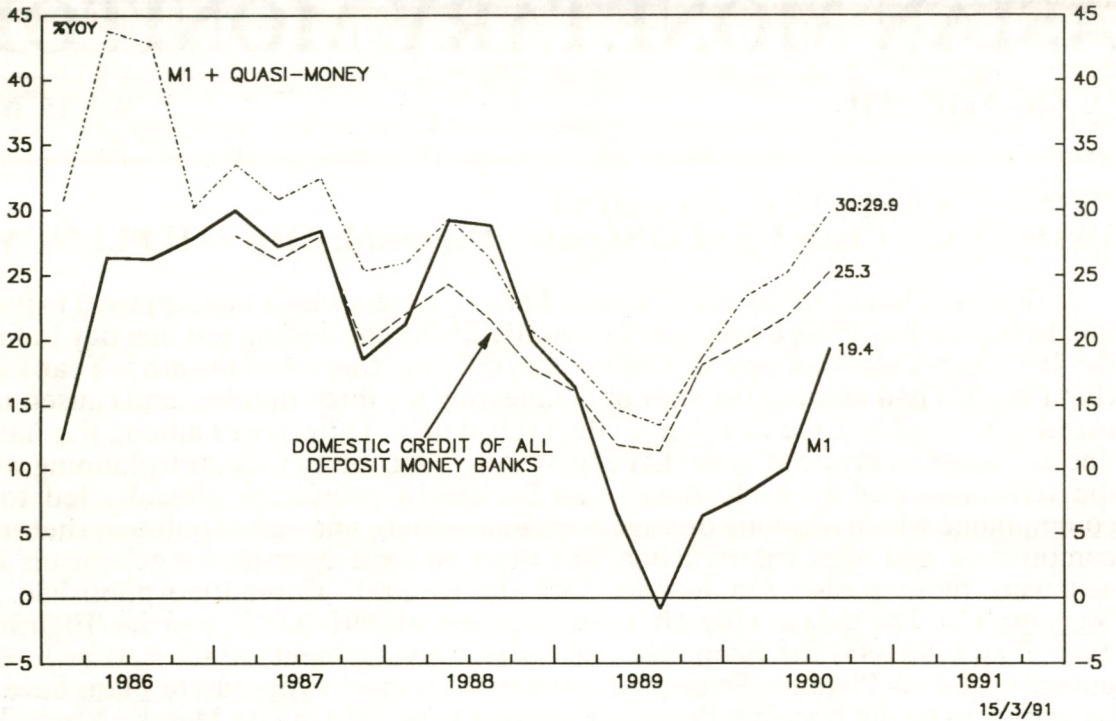
(1) Central Planning vs. Market Forces.

China continues to pursue the "bird in the cage" philosophy i.e. a limited role for market forces within a planned framework. Existing reforms are endorsed. Further price reform is to be "actively pursued in a prudent way", with a reduction in the scope of price-fixing by the central government. The two opposing factions clearly could not agree, so the Proposals imply that China can have the best of both worlds: "Planning can maintain a proportionate development of the national economy and a rational disposition of resources while market regulation can play the role of keeping the superior and eliminating the inferior and adding vigour to economic development." In reality, price reform is only likely to occur when market prices roughly coincide with state-determined prices, but these occasions are likely to diminish rather than multiply.

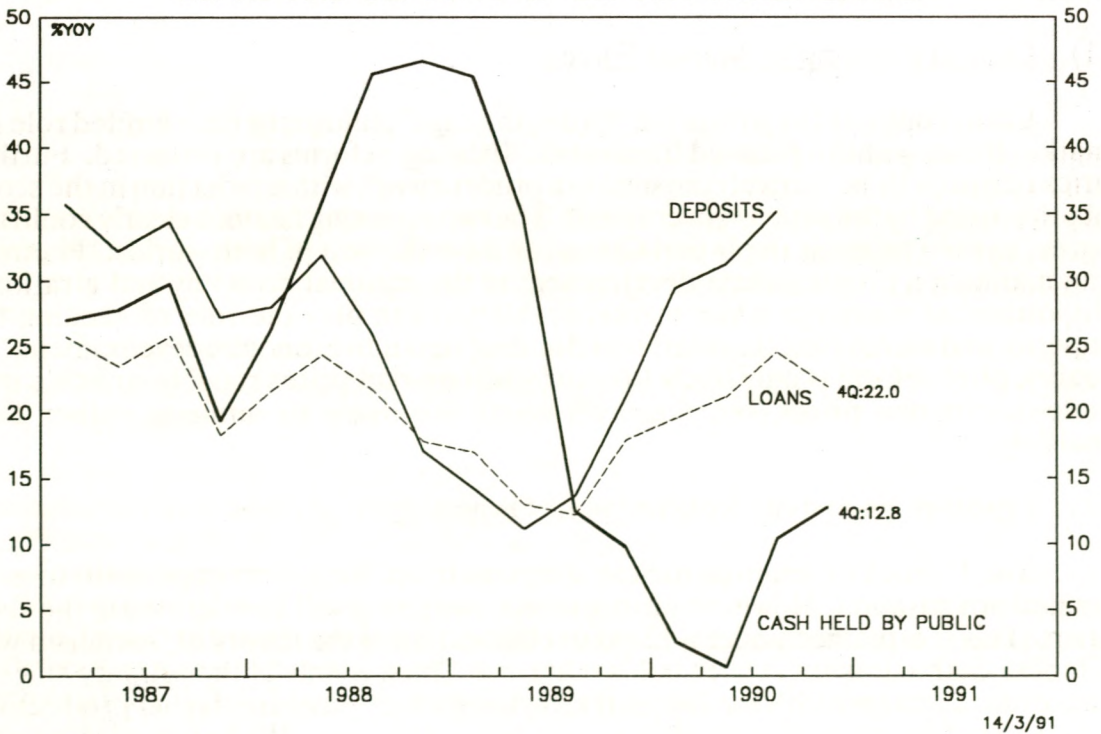
(2) Privatisation and the Role of Public Ownership.

The Central Committee indicated its continued long term opposition to even limited privatisation. However, private sector ownership will be tolerated in the short term. This is explained under a 12-point elaboration of the theory of "socialism with Chinese characteristics", which holds that since China is only at the primary stage of socialism (lasting possibly for 100 years), anything which generates higher productivity or greater efficiency should be allowed on a temporary basis. While the private sector

CHINA: CHART 1
MONEY AND CREDIT



CHINA: CHART 2
LOANS AND DEPOSITS OF DEPOSIT MONEY BANKS



is allowed, it will remain as a supplement to socialist public ownership. However, on the much discussed topic of enterprise reform, instead of experimenting with privatisation to solve the deficits of state-owned enterprises (SOEs), the Central Committee announced a scheme to "reinvigorate" 10,000 large and medium sized SOEs, basically through (i) mergers or restructuring (which will probably result in unprofitable SOEs being merged with profitable ones, and so drag them down) and (ii) separation of government and business operations i.e. reducing the role of political commissars assigned to SOEs.

(3) Investment Priorities, Credit Allocation and Inflation.

Instead of freeing up interest rates and letting the market decide where savings should be invested, the planners have decided to give preference to agriculture, energy, transportation, infrastructure and defence. As examples, output targets for grain and coal are to be increased substantially. (Not surprisingly these are also items which are sold at low, subsidised prices to consumers.) Lip service is paid to maintaining the so-called open door to the outside world and preserving the Special Economic Zones (SEZs), but new funding will mainly go to heavy industry in the provinces bordering the Yangtze River, particularly the Shanghai area, instead of the profitable light industry in China's southern provinces and SEZs.

As Charts 1-3 make clear, the Chinese authorities have already eased up very markedly on the credit squeeze, allowing bank lending of deposit money banks to grow by 25% year-on-year in the third quarter of 1990, slowing a little to 22% year-on-year in the fourth quarter. As a result broad monetary growth has roughly doubled since its trough in the third quarter of 1989. M2 accelerated from just under 13% to almost 30% in the third quarter of 1990, while narrow money (M1) surged from -1% to 19.4% over the same period. These rates of growth are too rapid to be sustainable without reigniting inflation, which raises the familiar question of whether China will be able to control monetary growth as the business cycle expansion gains momentum.

Neither the 5-Year Plan nor the 10-Year Programme say anything about ensuring monetary stability, or keeping monetary growth at rates which are compatible with low inflation. On their present course, and assuming the Chinese authorities do not introduce market interest rates to control credit expansion, it seems very likely that China will repeat the experience of 1983-84 or 1987-88 when monetary growth fuelled big surges in domestic spending and hence consumer price inflation (see Chart 3). Aside from a sharp recovery in output in the domestic economy, the first signs of serious overheating will appear in a deterioration of the external accounts (Chart 4) which are -- for the time being -- in a very healthy state.

(4) Subsidies.

A vague goal is set to reduce subsidies over time if opportune circumstances occur. Up to one third of the central government's budget is absorbed in subsidies (i) to keep certain key prices low to the consumer (i.e. the government is funding the difference between the price paid to producers and the price paid by consumers), and (ii) to keep a large number of SOEs afloat to maintain employment because China has no adequate safety net (i.e. unemployment insurance scheme, housing or food allowances etc.) for those who would lose their jobs by the closure of SOEs. The bankruptcy

law which was passed two years ago has never been implemented because of the huge number of people that might be affected. Approximately 50 million or one third of China's urban workers are said to be employed by SOEs. No timetable or target is given for ending the huge drain on central government finances from subsidies because this would clearly involve specific price reforms which the authorities seem unable to promise.

(5) The Responsibility System and the Role of Factor and Product Markets.

The responsibility system or household contract system which permits households to sell goods on the free market after meeting a state quota has been a central element of China's limited economic reforms to date. Rather than reducing the quotas or expanding the number of people covered by such schemes the communiqué reflects the stalemate in the struggle between conservatives and reformers. Extension of the reform process is advocated but then countered by some collectivist rhetoric. The result is the assertion of an economic contradiction, with equal weight put on opposing policies: "The household contract system will be maintained and perfected as a basic system. On this basis a dual operation system will be strengthened and perfected aiming at gradually expanding the collective economic powers."

While China has recently sanctioned the opening of stock exchanges in Shanghai and Shenzhen, these are perceived primarily as devices for raising funds for investment rather than as forums for the exchange of ownership rights. Indeed, the leadership continues to oppose even limited privatisation and opposes the development of a capital market in the fundamental sense of permitting the exchange at market prices of farms, factories, shops, homes etc. They seem determined to maintain state ownership or control of the factors of production (land, labour, capital), and only to permit markets in the products or commodities produced. But if resources are not free to follow where commodity prices lead, how rational can the pricing of the commodities be?

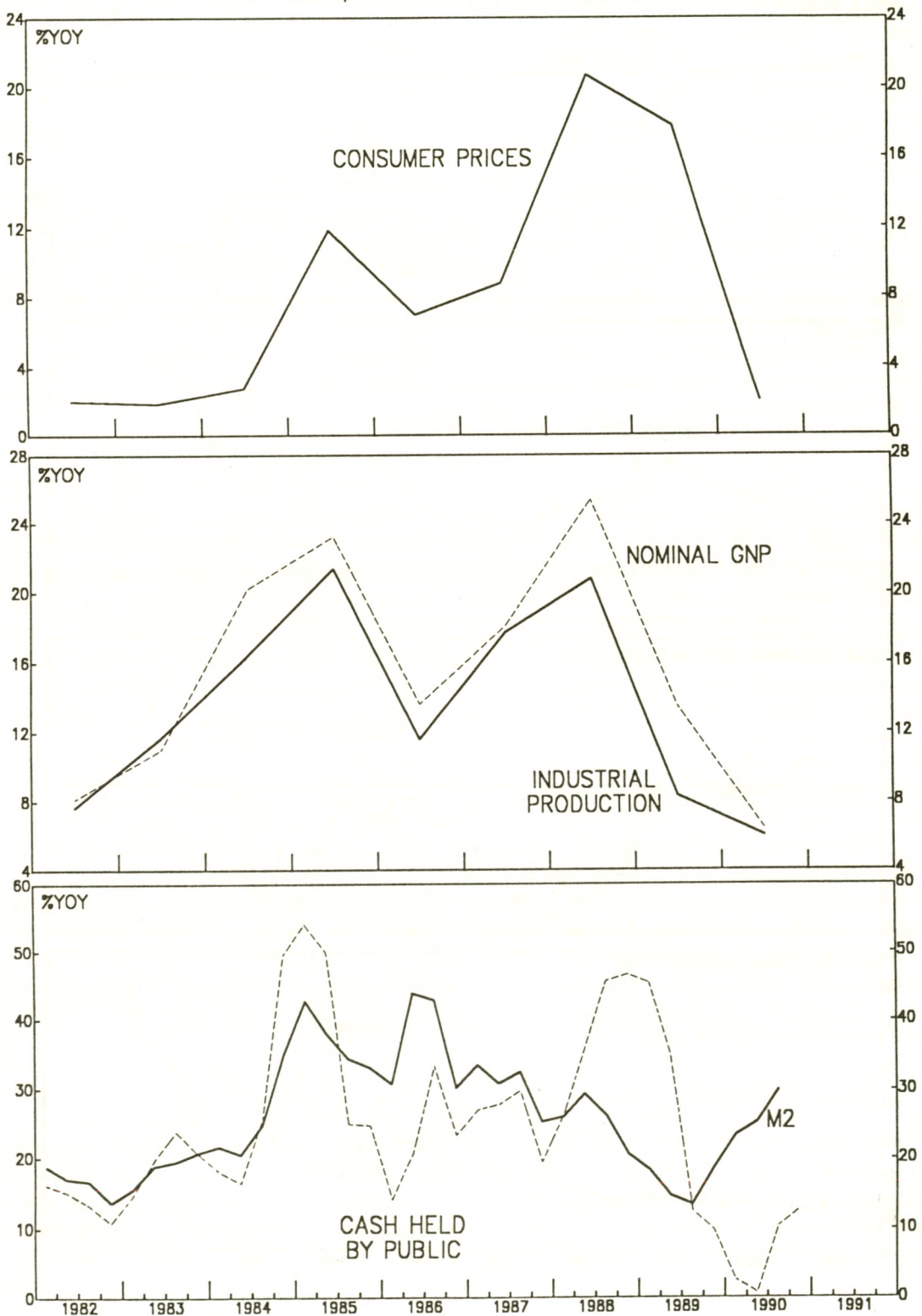
(6) Income Distribution.

This is another area where the drafters have had to paper over irreconcilable differences by means of contradictory assertions. They are willing to "allow a portion of the people to become rich first," through the responsibility system or through stock market profits (?), while expressing the intention to eliminate big gaps in income. Under the theory of "socialism with Chinese characteristics", there is a frequent compromise -- the agreement to use free market devices to benefit from the results while maintaining the pretence that this is only a temporary deviation from the achievement of socialism.

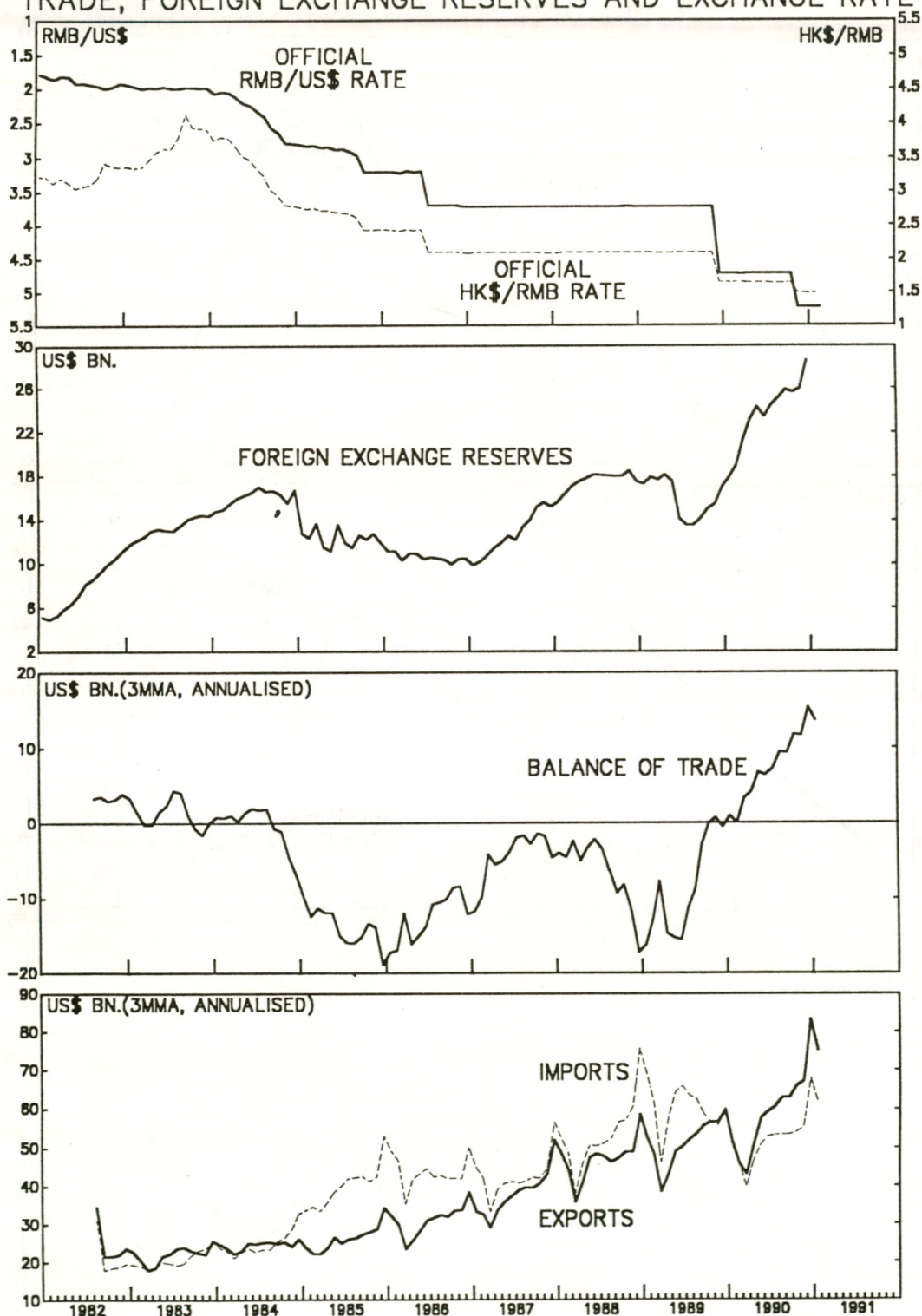
(7) The Tax System.

China has the worst tax system in the world. In essence every enterprise negotiates its tax liability with its local government on a one-by-one basis. Under this contract system fixed amounts are pledged to the state, but there is no uniform tax rate applicable to all enterprises or to types of enterprises. Taxes are collected by the local

CHINA: CHART 3
MONEY, OUTPUT AND PRICES



CHINA: CHART 4
TRADE, FOREIGN EXCHANGE RESERVES AND EXCHANGE RATE



government and some is passed on to the central government, but provincial officials have a strong incentive either to underreport tax revenues, or to siphon off whatever they can for local use. Late in 1990 the Prime Minister Li Peng had angered provincial officials by suggesting the abolition of the contract system and reserving a greater share of tax revenues for the central government. It seems that Mr. Li lost that battle, telling a pre-Plenum meeting that "increasing the sources of income" was the way to solve the central government's budget deficit. At the Plenum a decision was made to raise the fixed sums to be paid to central government, but not to change this system -- a victory for the provinces (which have achieved more autonomy during the past decade of reform) versus the central government. One result of this contract mechanism is that central government revenues do not expand in line with the growth of the economy, thus perpetuating central government deficits. Another result is that national tax policy is effectively set by the local governments which collect 70% of China's tax revenue.

CONCLUSION/FORECAST: The proposals for the 5-Year Plan (for 1991-95) and the 10-Year Programme (1991-2000) released at the end of January represent a hastily arranged compromise between two fundamentally irreconcilable views. With time running out at the end of 1990 the hardline central planners and the economic reformers agreed on the outlines of some muddled documents designed more to placate conservatives and liberals than to achieve any concrete changes. On the positive side one can say that at least the economic reform programme was not reversed, and that the "correctness" or legitimacy of past reforms was re-affirmed. After a decade of reform much of the Chinese economy now operates outside the plan, leaving the planners only with the ability to allocate credit and approve major new construction projects. On the negative side there are no new initiatives towards economic reform. Unspecified reforms are promised in several areas -- in taxation, banking, labour, wages, prices, and enterprise management -- but nothing concrete is proposed. Moreover, all of the major problems remain unresolved :-- the ill-structured tax system, the lack of private ownership and the resulting need for enterprise reform, the continuation of price controls for certain key commodities with government subsidising the difference between procurement price and sales price, and hence the persistence of central government deficits. The plan is less an economic plan than a political compromise -- an agreement not to rock the boat lest there is another bout of instability such as China experienced in 1989. In short, economic rationality was sacrificed to political expediency. For the longer term the direction of the economy is still not clear. Clearly the reforms are here to stay, but will they be significantly extended? Much will depend on the outcome of the leadership struggle when Deng Xiao-Ping disappears from the scene. Meanwhile the Chinese people can look forward to more of the same -- a modest degree of economic freedom, with the economy growing at far below its real potential, and subject from time to time to alarming surges of inflation which will threaten to bring a political reaction that reverses the economic reform process. For steady economic progress, China still requires fundamental political and economic reforms.

PEOPLE'S REPUBLIC OF CHINA

ENTERPRISE REFORMS AND MACROECONOMIC MANAGEMENT

Introduction

China has a partially reformed economy: the rural sector as well as collective and private enterprises are being operated in response to market forces, but state enterprises are being run according to administrative orders. While the prices of some goods and services are determined by supply and demand, the prices of others are highly regulated. This irrationality in the price system suggests that state enterprises should not be held responsible for performance. Their losses were tolerated and became a drain on the fiscal budget. Budget deficits were often monetised. Without effective independence, China's central bank -- the People's Bank of China -- tended to be merely a funnel for dispensing funds. The uncontrolled monetary expansion from time to time led to an explosion of domestic demand and high inflation.

The Status of Reforms

Although there are signs indicating that China's austerity programme has recently been softened, market-oriented enterprise reforms have made little progress since 1988. The contract responsibility system, which gives managers greater autonomy in return for promises to deliver specified amounts of output and taxes, remains in place. However, the central government has exerted greater control over the industrial sector through increased mandatory planning and control over input and output. The authorities' unwillingness to allow enterprise bankruptcies continues to inflict a drag on the economy and is pushing up subsidies. (See "Update on China's Economic Reform: the 7th Plenum", on p. 1 of this issue of AMM.)

Inefficiency and Instability

As indicated in a 1990 CIA report on the Chinese economy, the expanded scope of central planning is likely to erode incentives by reducing managerial autonomy and forcing factories to sell goods at low, state-set prices. Industrial efficiency is inevitably undermined. The increased allocation of raw materials and energy inputs to large state enterprises will further squeeze the dynamic private sector, hampering its contribution to economic growth. The present strategy of merging essentially bankrupt companies and their bloated work forces with healthy enterprises is likely to cause an additional drag on efficient production. Moreover, increased price and enterprise subsidies, combined with slower growth in state revenues, probably will increase the budget deficit.

According to the same report, much of China's economic instability is due to the incomplete nature of enterprise reforms. In the past decade, for example, the central government steadily increased the share of revenues that state enterprises would retain and gave them greater latitude over how funds were spent. At the same time, the central government failed to implement meaningful bankruptcy measures. Faced with no pressure of competition, many state-enterprise managers took advantage of increased decision making autonomy to expand investment spending and workers' remuneration without regard to efficiency.

Failure to complete price reforms has aggravated the difficulty in reforming

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state enterprises. Because the price of energy and raw materials are held artificially low, manufacturing industries can generally make profits even if factories use inefficient, outmoded equipment. Over-investment in the manufacturing industries as a result of price irrationality has increased the demand for chronically short supplies of energy and raw materials.

State enterprises also affect government finances through the buildup of inter-agency arrears and cross-debts. Sizable arrears can impede effective financial management because they obscure the true pattern of financing between the central government and state enterprises. Also, interlocking arrears accumulated among state enterprises can seriously undermine the financial discipline of this sector.

For example, say the public run railway company refused to pay state-owned engineering industries because of a shortage of funds due to the credit squeeze. In turn the engineering industries might not pay the state-owned steel industries; the steel industries might then refuse to pay the state power company. And the state power company might not fulfill its obligations to the central government: taxes, debt service and so on. As the government's budget deficit rose, credit would be further tightened, and the vicious circle would thus continue.

Strengthening State Enterprises Through Continuous Reforms

China's problem of financing state enterprises is a serious one because of their relative importance in the economy. But China is not alone. Recent fiscal crises have forced the governments of many developing countries to reconsider the role and management of state enterprises.

Official reports from India, Kenya, and Tanzania, for example, have drawn attention to the poor management of the state enterprise sector and to its budgetary implications. More than thirty governments have undertaken studies to identify weaknesses in the sector and its relations with government. More than ten developing countries have begun comprehensive reforms as part of broader efforts to improve resource mobilisation, allocation of public expenditures, and overall macroeconomic management. One approach is to reform pricing policies. Another is to increase competition. Ultimately, however, these attempts to reform state enterprises will not be very successful if there is no programme of privatisation, which is a subject too wide to be included here.

Reforming Price Policies

Rationalising pricing policies of state enterprises to reflect the opportunity cost of production can have many benefits. It can make state enterprise operations and investments self-financing, thus reducing the state enterprises' contribution to the overall public sector deficit. This facilitates the pursuit of sound public finance policies. For example, it alleviates the pressures on central government to raise taxes, which are often costly in terms of administration and the economic distortions they cause. It also alleviates pressure to raise financing through inflation, taxation, or borrowing abroad. In addition, rational pricing helps to limit the overall imbalance between savings and investment in the economy, thus reducing pressures on the balance of payments.

Better pricing can also improve the efficiency of resource allocation, provided

prices or user charges are set to reflect economic cost. Where state enterprises produce internationally traded goods, prices in international trade -- also called "border prices" -- are generally the appropriate reference point. The coal industry provides an example. In China, the domestic price was often set below border prices. The implicit subsidy to users was met by grants, equity contributions, or loans from government to coal-producing state enterprises. This encouraged inefficient use and excessive expansion of capacity in the energy-intensive sector. For state enterprise outputs not traded internationally -- for example, power, water, and telecommunications -- the long-run marginal cost of production is the basis for efficient pricing. Underpricing leads to under-capacity in these sectors, unnecessary burdens on the government budget, and excessive foreign borrowing by the state enterprises concerned. There will almost always be political difficulties in rationalising prices. Small but frequent price increases in line with broad factors affecting costs may help to alleviate these difficulties.

Enhancing Financial Discipline

Financial discipline is more than a matter of controlling borrowing and allocating spending more efficiently. Clearing inter-agency arrears can be a laborious and expensive exercise, but it can greatly increase the transparency of state enterprise finances.

The most effective measure to enhance the financial discipline of state enterprises would be the vigorous implementation of the bankruptcy law. Bankruptcies are the ultimate weapon of the economy to control business inefficiency. Although they will encounter serious financial, managerial, and political constraints, they are essential to any meaningful enterprise reforms. To help overcome political resistance, greater transparency is needed to demonstrate the costs of unviable or poorly managed state enterprises. The challenges call for government commitment and adequate resources to support adjustment.

Increasing Competition

In many areas, exposing state enterprises to domestic and foreign competition would promote economic efficiency. This means, as a rule, removing several forms of protection, including budgetary subsidies. In India, public bus companies have performed better in cities where they are fully exposed to competition without subsidy than in cities where subsidies and inappropriate incentives have fostered inefficiency.

State enterprises are also being protected by regulated domestic markets that keep out private competitors. Eliminating state marketing monopolies in China led to big gains in agricultural efficiency and drew greater output from private farmers and collectives.

Tariffs or import quotas protect Chinese state enterprises from foreign competition and make their inefficiencies less transparent. Some industrial state enterprises were profitable in terms of domestic prices, but when their inputs were valued at world prices, many enterprises were producing negative value-added. In other words, the output for the enterprise was worth less than its inputs. Allowing a greater role for the private sector in the economy will certainly improve overall economic efficiency as private agents always respond faster to market signals and generally adapt more quickly to the removal of trade distortions than state enterprises.

Concluding Remarks

As the failure of enterprise reforms is a major cause of economic inefficiency in China, and budgetary deficits are in turn the source of monetary instability it is clear that microeconomic reform rather than macroeconomic control is the key to maintaining the long-term stability of the Chinese economy. It is hardly surprising that in the financial markets and business communities of the West the early enthusiasm about China is turning to scepticism. If enterprise reforms are proving so difficult for China, will it not prove impossible for the country to depart from its "stop-go" pattern of economic growth?

SINGAPORE INTEREST RATES TO FALL, INFLATION TO RISE

Introduction

Singapore is clearly past the peak of its business cycle in terms of GDP growth (Chart 1). During the last quarter of 1990 export growth partially recovered its momentum helped by the rise in oil prices during the early stages of the Gulf crisis. Domestic non-oil exports, however, grew at a slower pace. A reversal of the overall declining growth trend in exports will be largely dependent on the performance of the US economy, the single most important customer of Singapore. Official forecasts for the GDP growth rate for 1991 vary from a low of 3% to a high of 6%.

As indicated, the duration and relative severity of the downturn in economic activity in Singapore will be partially determined by external factors. In a small, open economy such as that of Singapore the authorities can control the level of aggregate demand primarily through foreign exchange rate policy. This does mean that the authorities have to abdicate control over money stock and therefore over interest rates. It would also follow that there is a trade-off between the rate of inflation the authorities are willing to tolerate and the real or effective exchange rate implicit in the ruling nominal rate.

In the case of Singapore where the authorities have repeatedly demonstrated their willingness to pursue an active foreign exchange rate policy, the consequences of fiscal development or movements in the balance of payments, particularly in the capital account, have generated in the past situations which proved difficult to resolve.

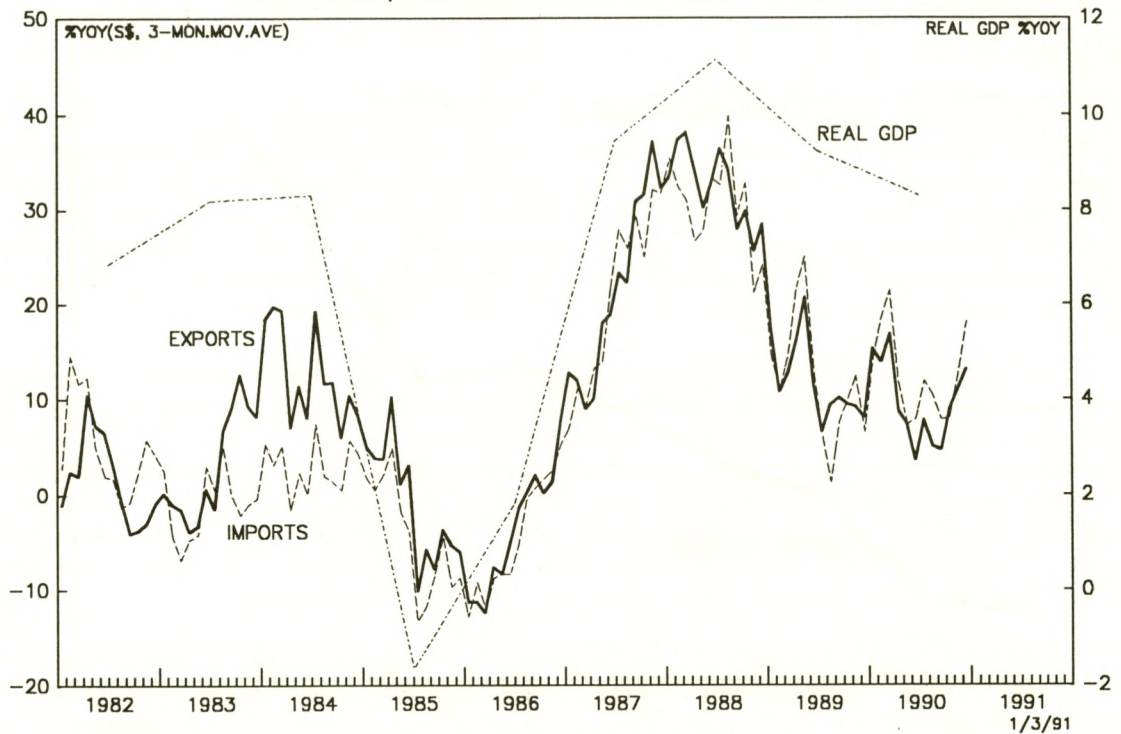
For example, during 1980-85 the rapid expansion of the fiscal surplus led to a liquidity drain in the economy. The Monetary Authority of Singapore (MAS) chose to maintain a relative high exchange rate against the US dollar rather than offset the balances withdrawn from the financial system by the government. The outcome was the sharp, deep recession of 1984-86 which was only reversed when fiscal policy was considerably relaxed towards the middle of 1985 and consequently liquidity eased.

Currently a combination of an easing of the public sector's monetary surplus plus the effects of an overall surplus in the balance of payments is causing a rapid increase in the liquidity of the financial system. That in itself might not be disturbing particularly in view of the stage of the business cycle of the Singaporean economy. There are, however, some very important implications concerning the future movement of the exchange rate and the rate of inflation. Both these issues impact directly on Singapore's competitiveness in the international markets and could easily shape the next phase of its business cycle.

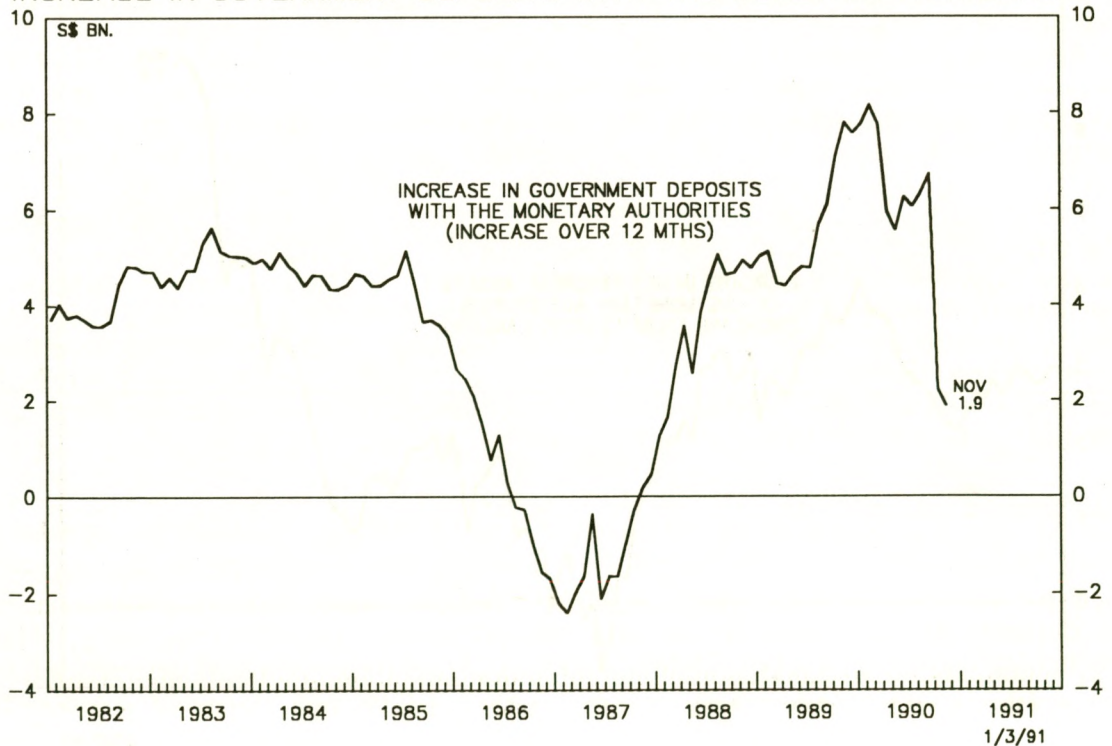
Components of Liquidity

The public sector's monetary surplus is reflected in the amount of deposits held by the government with the MAS. As Chart 2 indicates since January 1990 increases of deposits of the public sector with the MAS have been on declining trend, particularly so after October. Indeed during that month government deposits fell by S\$3.3 bn, the largest fall in nearly ten years. As a comparison, this decline was even

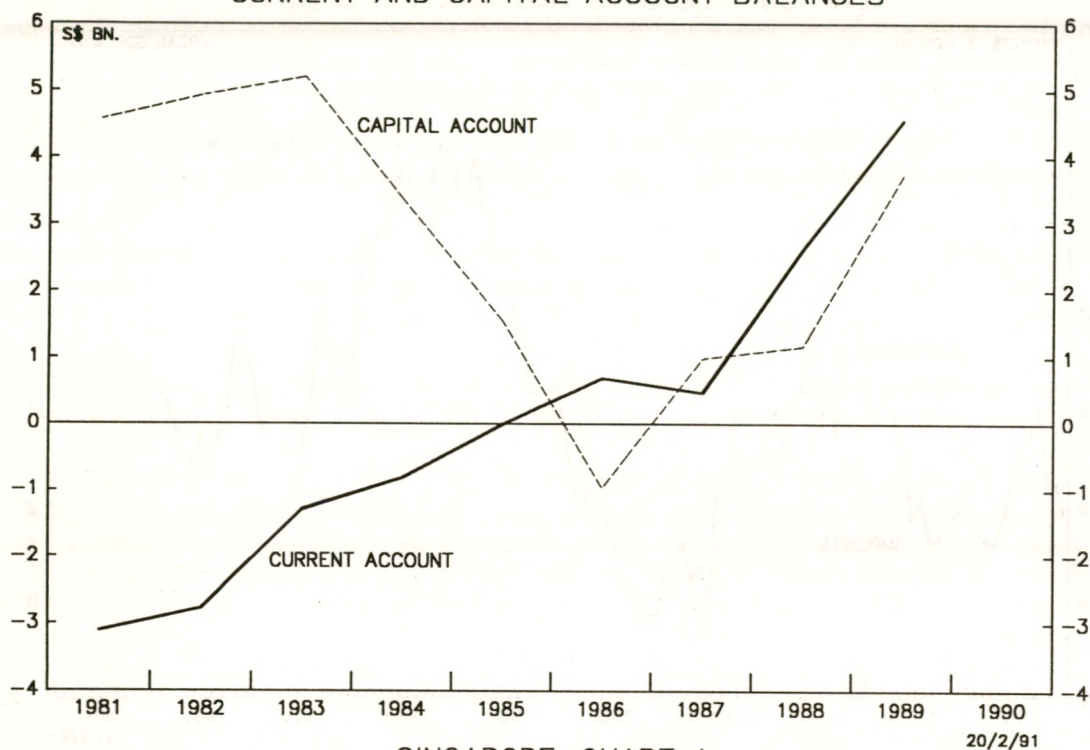
SINGAPORE: CHART 1
REAL GDP, EXPORTS AND IMPORTS GROWTH



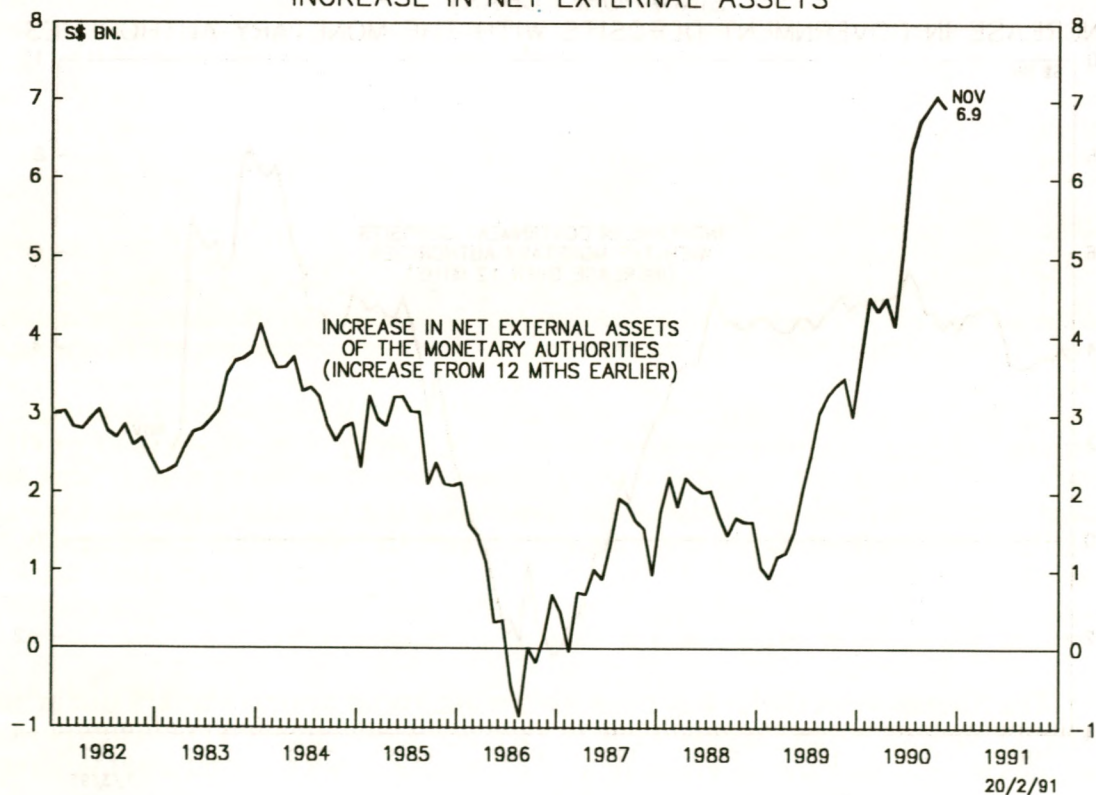
SINGAPORE: CHART 2
INCREASE IN GOVERNMENT DEPOSITS WITH THE MONETARY AUTHORITIES



SINGAPORE: CHART 3
CURRENT AND CAPITAL ACCOUNT BALANCES



SINGAPORE: CHART 4
INCREASE IN NET EXTERNAL ASSETS



sharper than that which occurred during late 1985 when the government was urgently reversing its restrictive fiscal policy whilst the economy was troughing. As government deposits are effectively outside the banking and financial system, a fall in their size represents a reinjection of liquidity.

The surplus in the current account since 1986 and in the capital account since 1987 (Chart 3) have resulted in growing foreign exchange reserves. This is shown in Chart 4 by the overall positive growth in the acquisition of net external assets by the MAS, particularly since the last quarter of 1988. Given that the MAS follows a strict foreign exchange rate policy, the implicit appreciation of the Singaporean dollar was contained as the MAS swapped the local currency for US dollars. This action also added to the liquidity of the banking and financial system.

The Singaporean government also maintains deposits directly with the banking sector. A rapid increase in these could have a negative impact on the conventionally defined money supply growth (M1 or M2), since these deposits are not included. That negative impact would not, however, extend to the banks' reserves as an increase in government deposits would represent a transfer from the private to the public sector. Between January and November 1990 on a month-by-month basis government and statutory authority deposits increased by S\$820 mn net which, by comparison, represents a small percentage (16%) of the November's net injection of S\$5.1 bn in the economy.

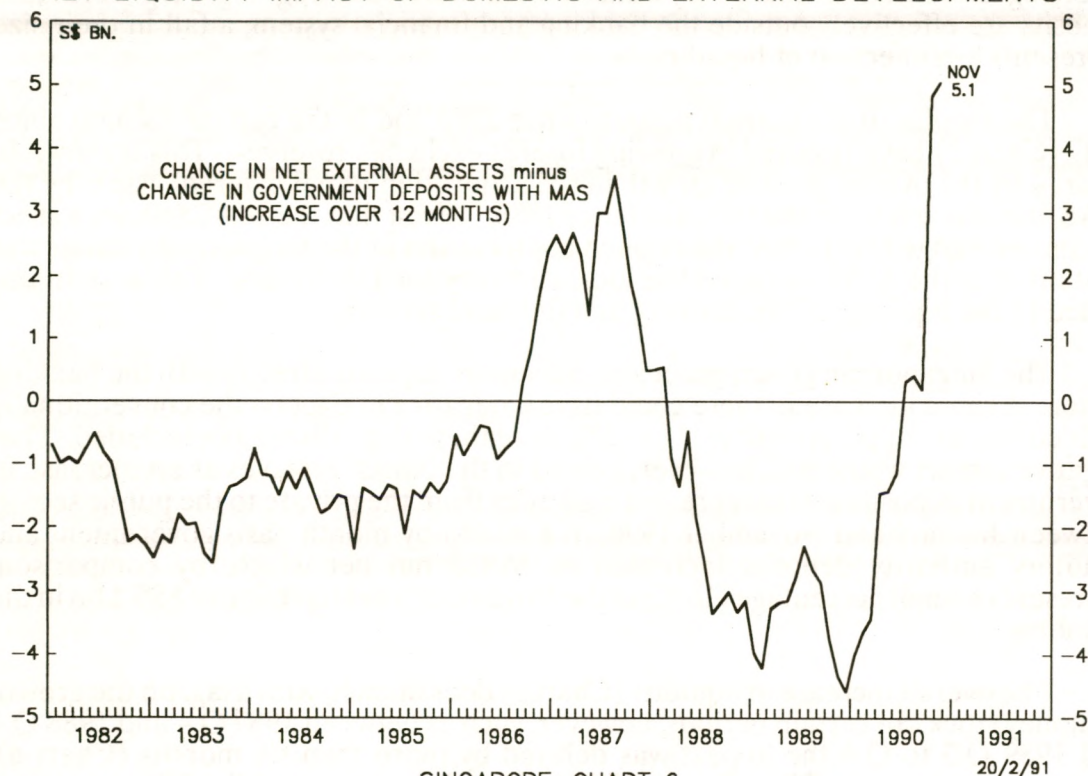
The overall increase in liquidity (Chart 5) does impact, with a lag, on the growth of money stock. In certain periods, however, such as between 1987 Q.4 and 1988 Q.1 and 1989 Q.3 to Q.4 the impact was delayed by more than six months (Chart 6). However, as shown by Chart 7, even if the effect of the increased liquidity on money growth is lagged, that on interbank interest rates is not. The sharp decline in interbank rates since August 1990 coincided perfectly with the accelerated and positive liquidity injection, as shown in Chart 5. Prime rates also followed interbank rates except, that a current gap of nearly 300 basis points between them indicates an increasing pressure on banks to extend their lending and/or lower prime rates even more.

Inflation and the Exchange Rate

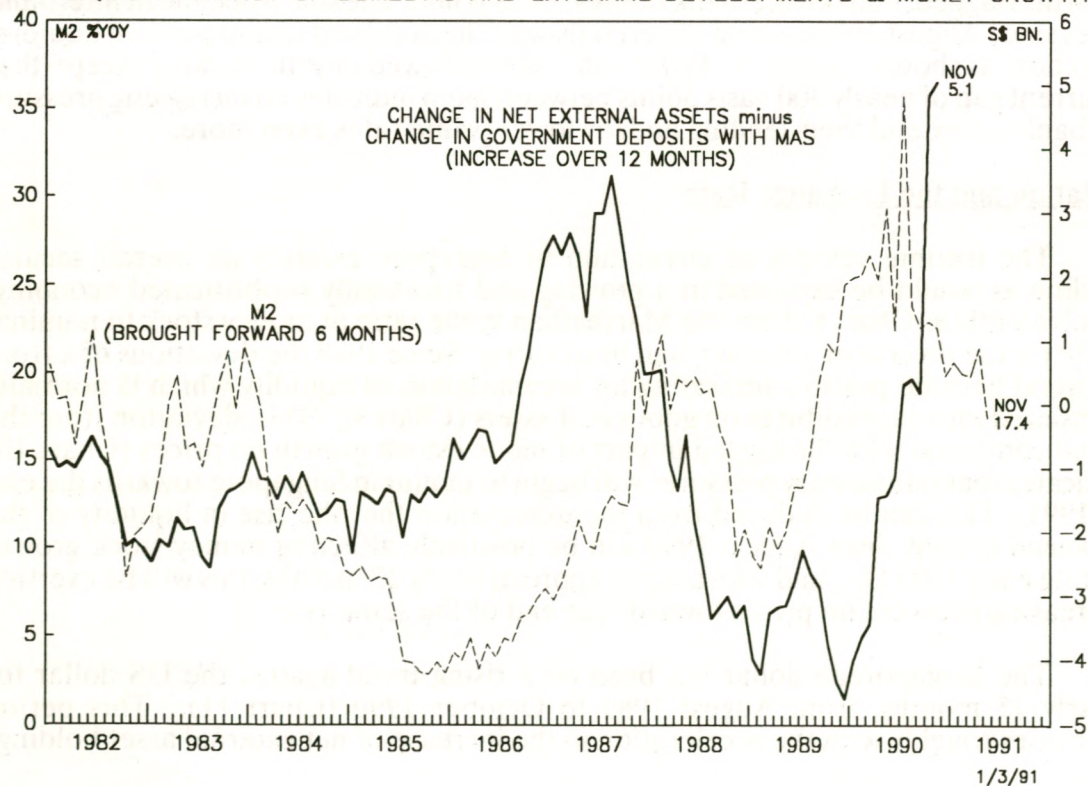
The income velocity of circulation in Singapore exhibits an overall secular decline as would be expected in a growing and financially sophisticated economy. Equivalently as Chart 8 shows the Marshallian k , the ratio of money stock to nominal GDP (ie the inverse of velocity), had been rising. Since 1989 the deviations of k from its trend became positive indicating an accumulation of liquidity which is normally translated into expenditures on goods and assets (Chart 9). This deviation from the trend combined with the lagged impact of money stock growth on prices (Chart 10) indicates that inflationary pressures will begin to mount in Singapore towards the end of 1991. This can be deduced from the expectation that the rise in liquidity of the financial system since August 1990 will be positively affecting money stock growth during early 1991 Q.1, and with a lag of approximately 12 months, this will be exerting increasing pressure on prices towards the end of the same year.

The Singaporean dollar has been on a rising trend against the US dollar for nearly 15 months, from August 1989 to October 1990 (Chart 11). This period coincides roughly with the acceleration in the increase of net external asset holdings

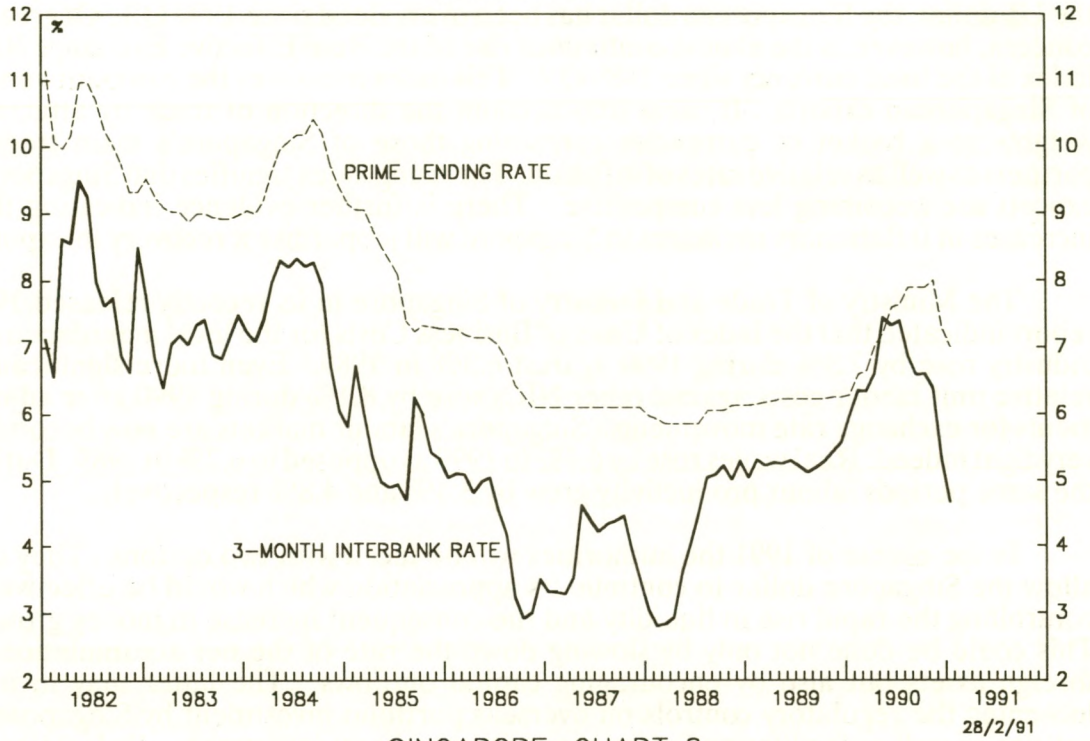
SINGAPORE: CHART 5
NET LIQUIDITY IMPACT OF DOMESTIC AND EXTERNAL DEVELOPMENTS



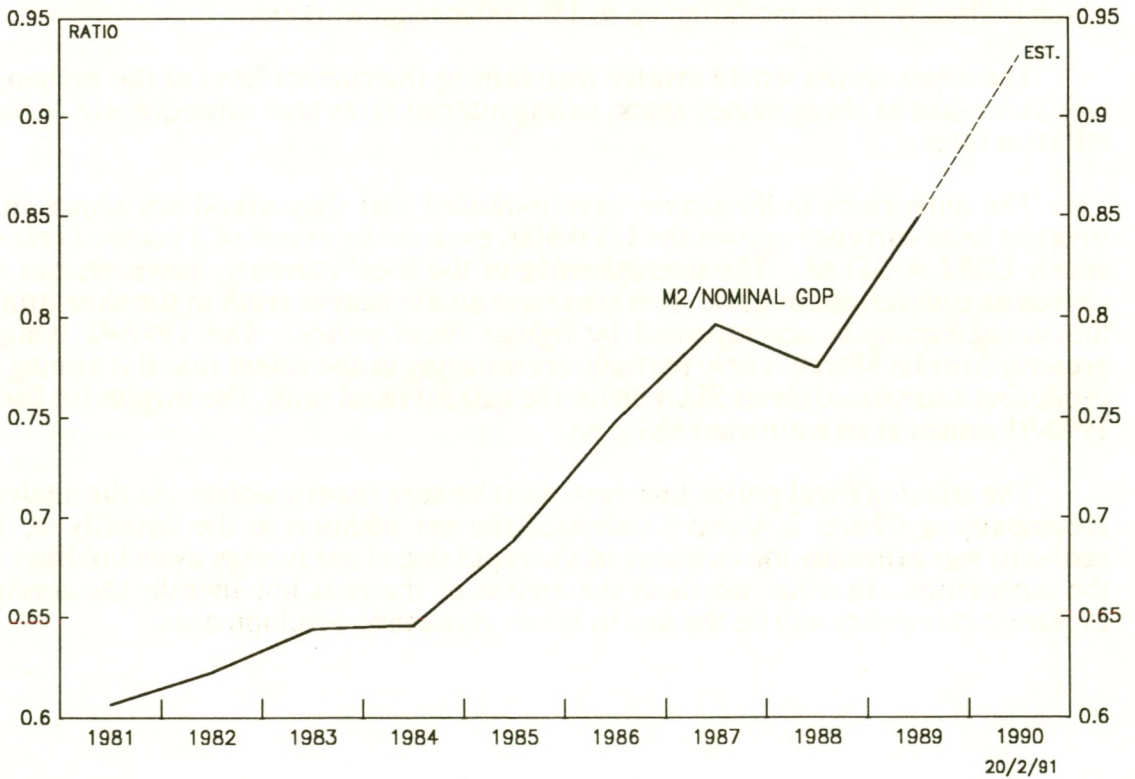
SINGAPORE: CHART 6
NET LIQUIDITY IMPACT OF DOMESTIC AND EXTERNAL DEVELOPMENTS & MONEY GROWTH



SINGAPORE: CHART 7
INTEREST RATES



SINGAPORE: CHART 8
MARSHALLIAN k



of the authorities (Chart 4) implying that the local currency would have appreciated even more had it not been for that intervention. In terms of its PPP valuation against the US dollar, the Singaporean dollar has been overvalued since 1990 Q.1. Of greater concern, however, is the almost continuous rise of the Real Effective Exchange Rate index of the local currency since 1989 Q.4. This index measures the competitiveness of Singaporean exports. It takes into account the direction of trade by attaching weights to a basket of currencies containing those of Singapore's main trading partners as well as relative rates of inflation. The rising index signifies that Singapore's exports are becoming less competitive. There is further evidence indicating that increases in inflationary pressures in Singapore will jeopardise a recovery in exports.

The Ministry of Trade and Industry of Singapore in its recently released 1990 report indicated that the index of Units of Business Costs for the local manufacturing industry rose by 7.3% during 1990 against 6.3% in 1989. Even more significantly relative unit labour costs against other NICs rose by 8.1% during 1990 after adjustments for exchange rate movements. Singapore's labour markets are now becoming very tight indeed. Real wages rose by 6.4% in 1990 as opposed to 6.2% in 1989. During the same periods labour productivity grew by 3.4% and 4.8% respectively.

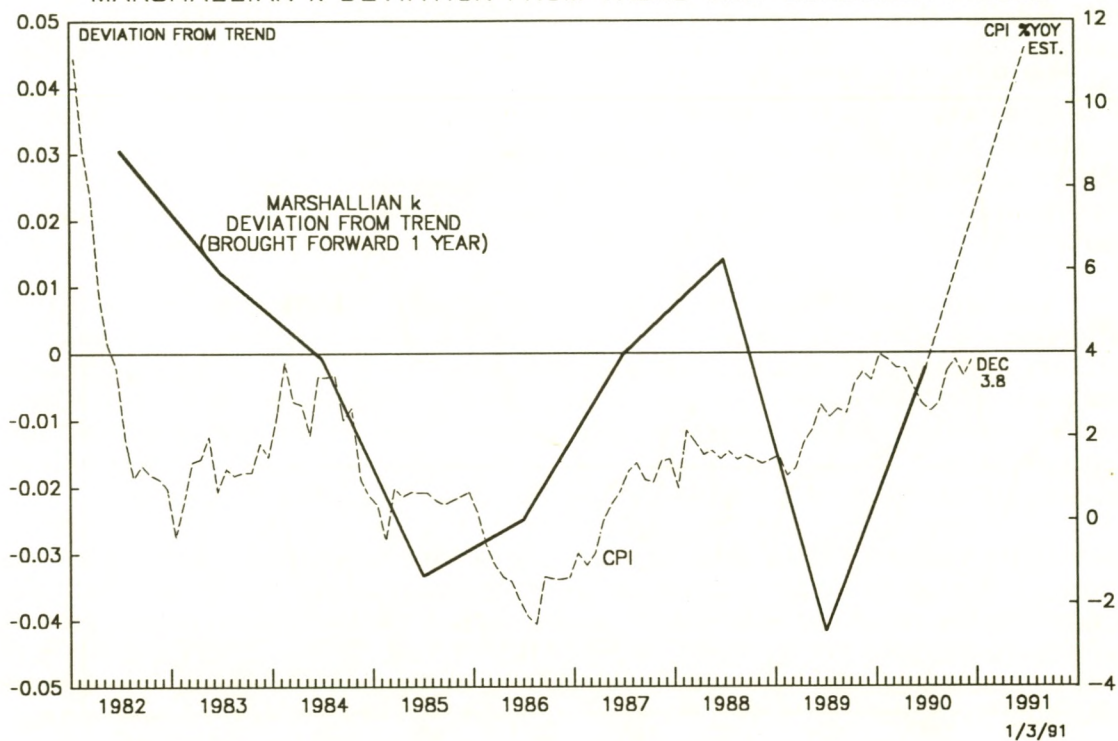
In the course of 1991 the authorities will be faced with two options. They can allow the Singapore dollar to continue its appreciation which would be effective in controlling the rapid rise in liquidity and the consequent increase in money growth. This could be done not only by slowing down the rate of the net accumulation of foreign assets but also by encouraging capital outflows. The latter may involve loosening the regulatory controls on overseas portfolio investment by Singaporean entities as well as facilitating Singaporean foreign direct investment. Relocation of production would provide a partial solution of the increasingly tight labour market which is already accommodating up to 150,000 foreign workers.

The other option would involve maintaining the current level of the exchange rate at the cost of rising money stock, falling interest rates and, subsequently, higher inflation rates.

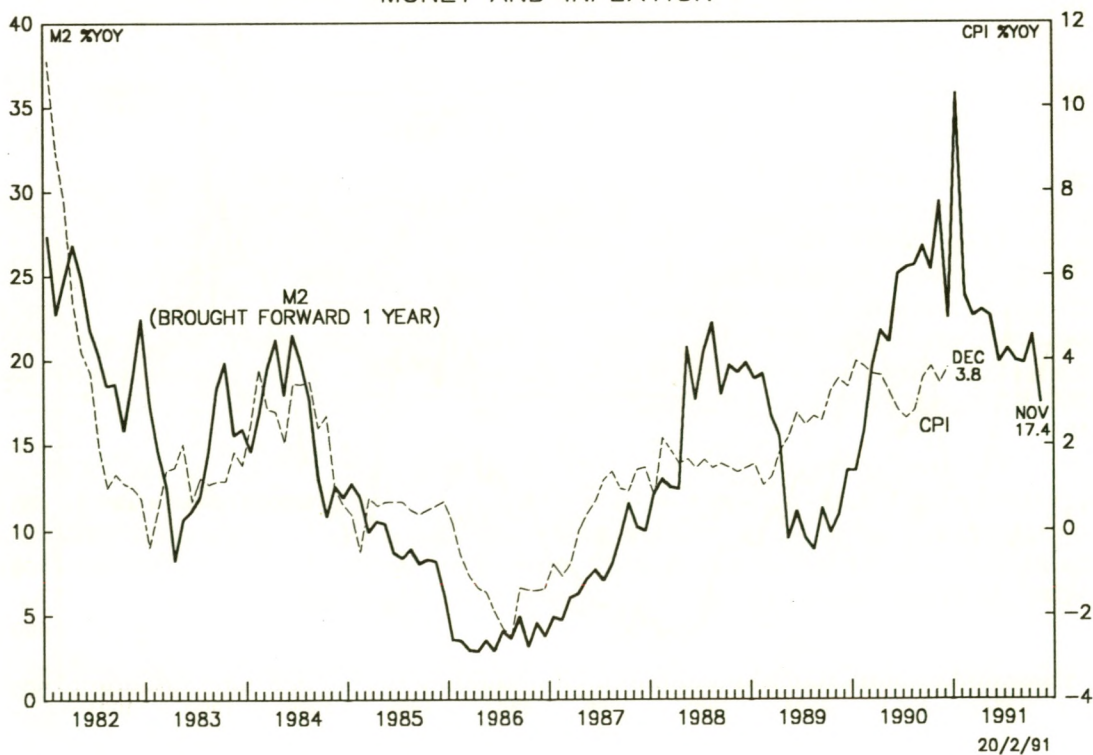
The authorities in Singapore have indicated that they would not object to a stronger local currency against the US dollar, even to the extent of a yearend rate of nearly US\$1 = S\$1.68. The strengthening of the local currency, however, can be viewed as counterinflationary. This may have an element of truth in the short run if the strengthening is accompanied by tighter fiscal policy. The 1991-92 budget presented on 1st March is only partially encouraging to the extent that it is aiming at producing a surplus of about S\$1.4 bn for the current fiscal year. The surplus for fiscal 1990-91 stands at an estimated S\$3.2 bn.

The effect of fiscal policy, however, must be kept in perspective. As the analysis accompanying Charts 2, 4 and 5 indicated the net addition to the liquidity of the economy was primarily the outcome of the rapid rise of net foreign asset holdings by the authorities. In other words in the course of the next few months the foreign exchange rate policy will be the key to future monetary developments.

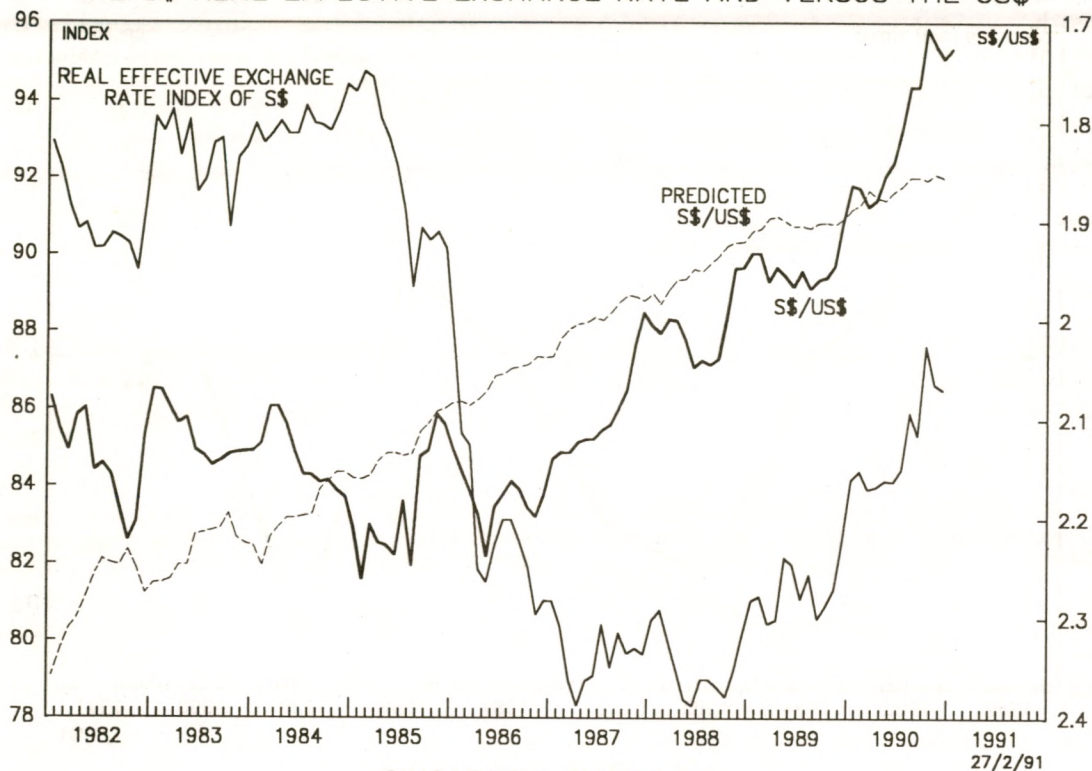
SINGAPORE: CHART 9
MARSHALLIAN k DEVIATION FROM TREND AND CONSUMER PRICES



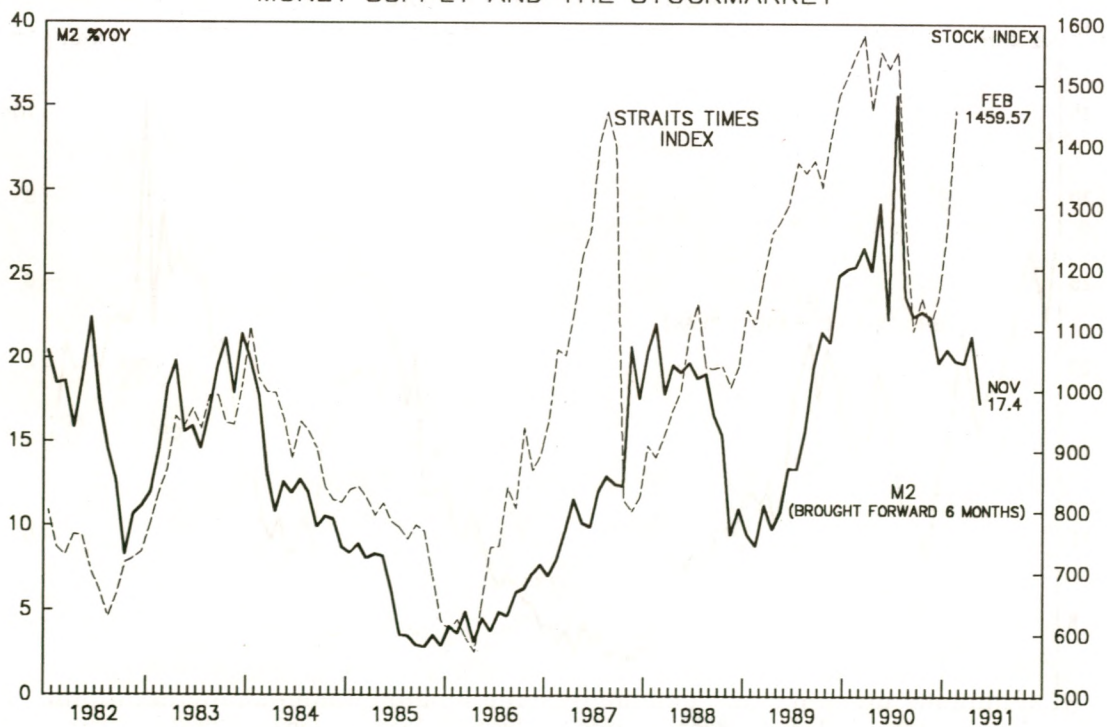
SINGAPORE: CHART 10
MONEY AND INFLATION



SINGAPORE: CHART 11
THE S\$ REAL EFFECTIVE EXCHANGE RATE AND VERSUS THE US\$



SINGAPORE: CHART 12
MONEY SUPPLY AND THE STOCKMARKET



FORECAST: Interest rates in Singapore will be falling with prime rates coming down by at least 100 to 150 basis points during the course of the year. Real prime rates are already low, currently at about 3.6%. Since the inflationary pressures caused by the current rise in liquidity will not be appearing until the end of the year, real rates may actually fall even more as nominal rates come down. All this should be quite bullish for an equity market which staged a significant comeback since January 1991 when the Straight Times Index stood at 1153 to its current level of 1462 (1/3/91). Furthermore as Chart 12 indicates that there is a reasonably close link between lagged changes in money stock and the level of the index, which augurs well for the stock market given the expected acceleration in the growth of M2.

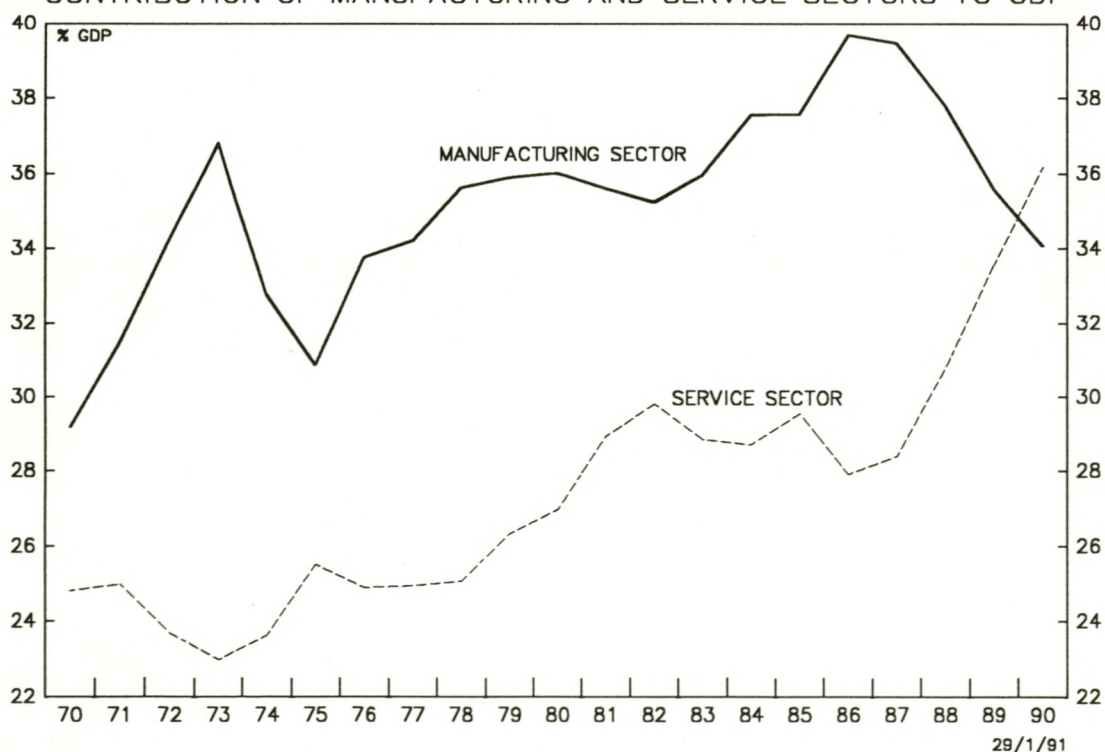
On the downside, however, the rapid increase in M2 during 1989 is likely to be compounded by its acceleration during 1991 as well. Despite the fact that Singapore is now on the downward path of its business cycle, the economy still suffers from considerable bottlenecks particularly in the labour front. Inflationary pressures will rise in the course of 1991 and, at worst, could cause the CPI to rise at double its current rate of increase of about 4.0% to nearly 8.0% p.a.

TAIWAN FIXED INVESTMENT GROWTH IS THE KEY TO ECONOMIC RE- COVERY

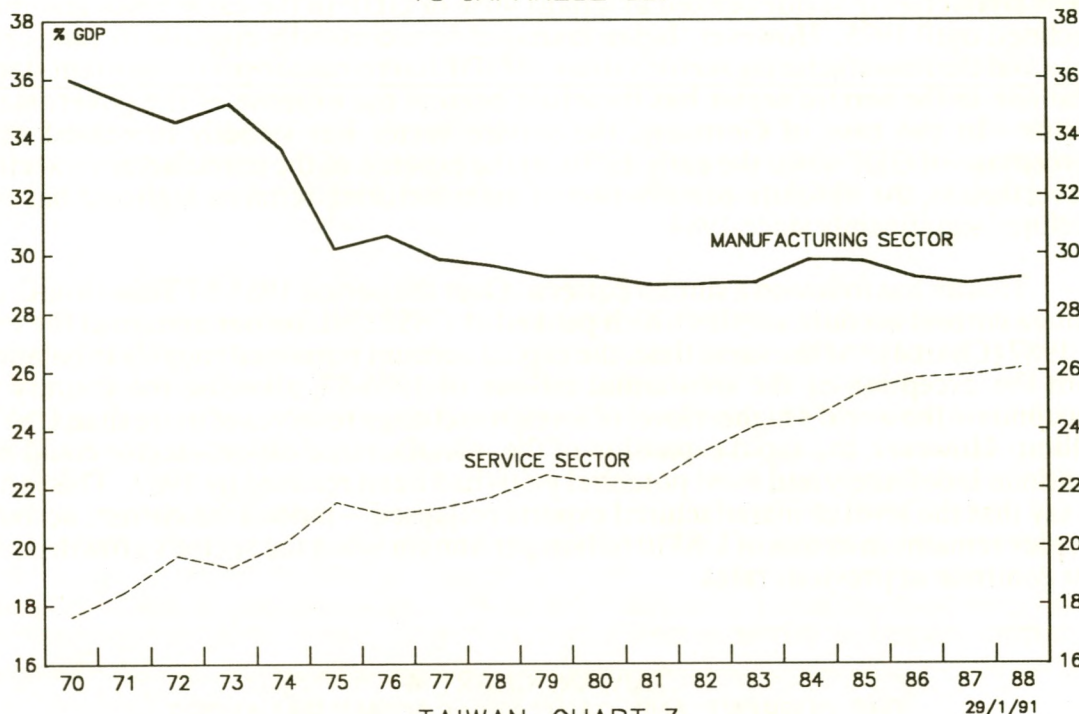
The Taiwanese economic miracle of average annual real GNP growth of 8.7% over the period 1971-90 has been well documented. This success was based on numerous small and medium sized enterprises producing cheap, manufactured goods for export. However, manufacturing as a percentage of GNP has been declining since 1987 (Chart 1) while the service sector has continued to expand. Similarly, exports as a percentage of GNP have fallen to around 45% since reaching a peak of 56% in 1987, while private consumption has risen to over 50% of GNP for the first time since 1985.

This pattern of economic development follows the experience of developed economies, such as Japan and West Germany. Typically, the manufacturing sector drives the initial acceleration of output which is reflected by an accumulation of a large current account surplus and an appreciation of the currency. The resulting rise in domestic incomes is then accompanied by an increase in the size of the service sector to meet the incremental demands and expectations of consumers. Finally, the growth of the manufacturing sector starts to slow as rises in both the internal costs of production and the external value of the currency result in a loss of competitiveness. At this stage, low technology manufactured goods start to be produced in less developed countries and the economy has to upgrade its manufacturing sector and/or further expand its service sector.

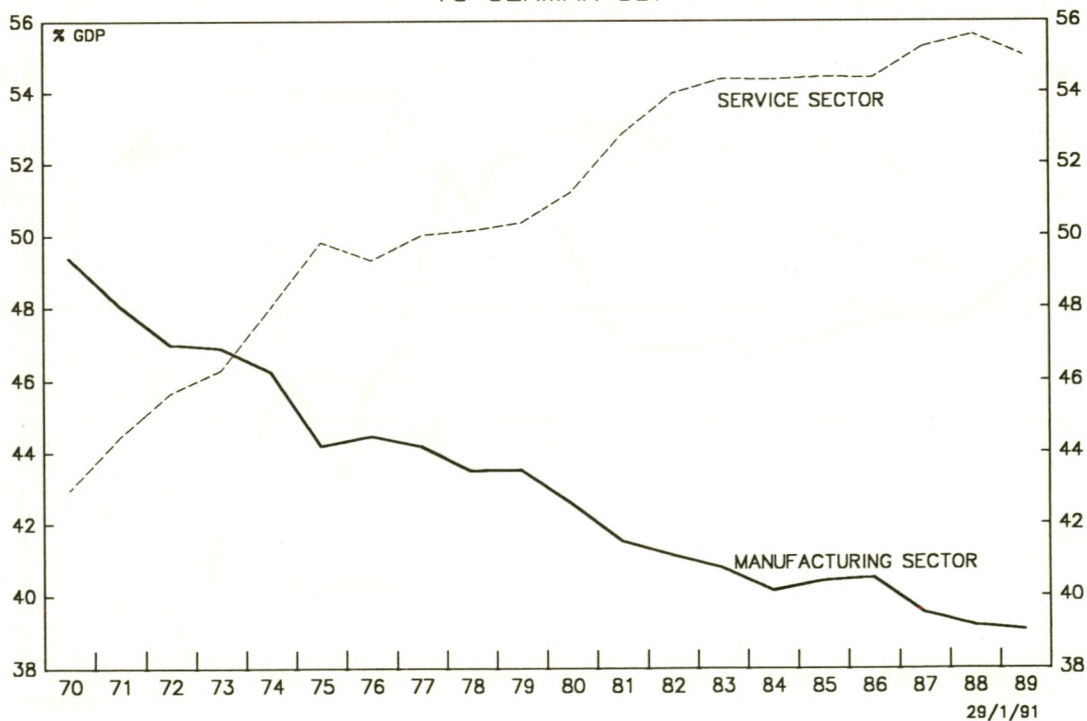
TAIWAN: CHART 1
CONTRIBUTION OF MANUFACTURING AND SERVICE SECTORS TO GDP



TAIWAN: CHART 2
CONTRIBUTION OF MANUFACTURING AND SERVICE SECTORS
TO JAPANESE GDP



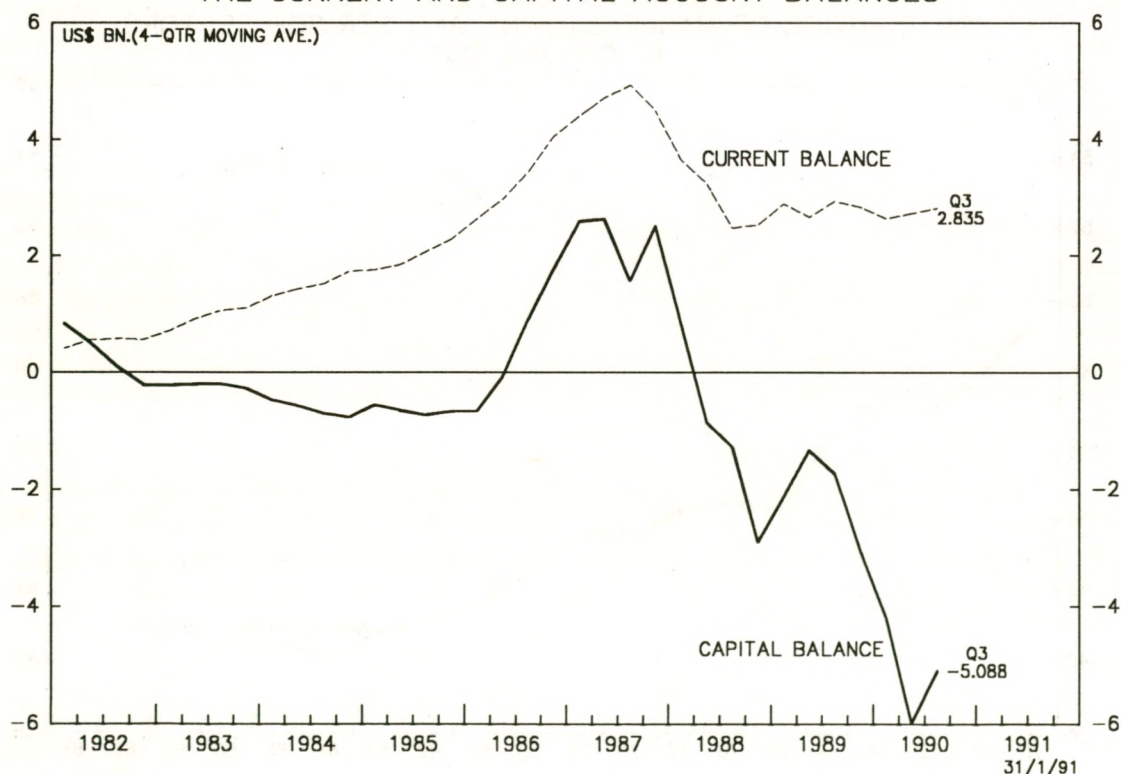
TAIWAN: CHART 3
CONTRIBUTION OF MANUFACTURING AND SERVICE SECTORS
TO GERMAN GDP



Looking at the experience of Japan and Germany (Charts 2 and 3), it can be seen that their service sectors have been rising steadily as a percentage of GDP. In Japan, the manufacturing sector peaked at almost 40% of GDP in the early 1960s and then declined until 1975. However, Japan managed to successfully upgrade its industrial base and the manufacturing sector's share of GDP has remained pretty constant since. The rise in the service sector has therefore been at the expense of the government sector. In the case of Germany, the service sector has steadily increased as a percentage of GDP since the early 1950s, at the expense of the manufacturing sector. Nevertheless, the absolute contribution of manufacturing remains high and has not declined significantly since 1984.

Taiwan has followed a similar pattern. Over the period 1981-87 Taiwan built up a huge current account surplus which peaked at US\$22 billion per annum at the end of 1987 (Chart 4). At the same time, the capital account remained roughly in balance, with the exception of the substantial inflows of 1986-87, allowing the country to accumulate the world's highest level of foreign exchange reserves of more than US\$70 billion. However, the rapid expansion of the manufactured exports sector could not continue indefinitely and most potential gains had been realised by 1987. This is not to say that the level of manufactured exports collapsed -- indeed the current account surplus remains in excess of US\$10 billion per annum -- but the sector's growth could not continue at previous rates.

TAIWAN: CHART 4
THE CURRENT AND CAPITAL ACCOUNT BALANCES



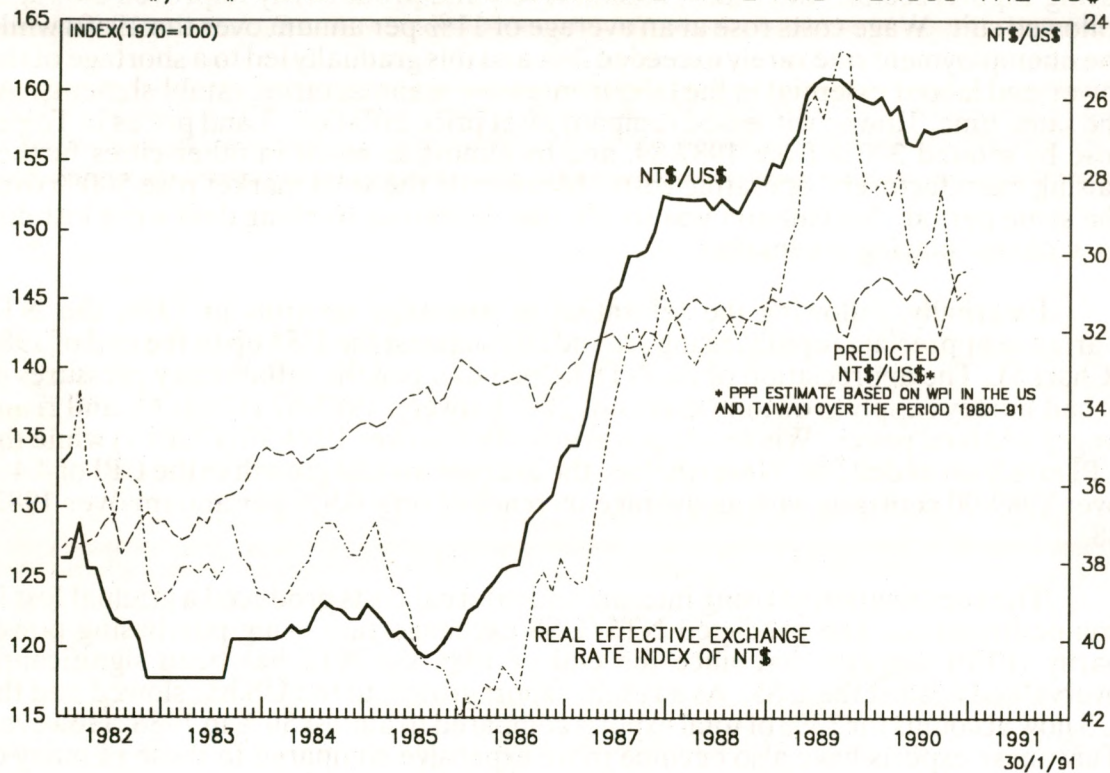
A number of factors contributed to the slowdown in the growth of the manufacturing exports sector. Internally, as skill levels and productivity improved so wages followed suit. Wage costs rose at an average of 11% per annum over the 1980s while the unemployment rate rarely exceeded 2%, and this gradually led to a shortage of the lower-end labour essential to the labour-intensive manufacturing establishments. At the same time, Taiwan witnessed rampant asset price inflation. Land prices in Taipei rose by around 300% from 1987-89, and by almost as much in other cities further raising manufacturers' operating costs. Meanwhile the stockmarket rose 500% over the same period. Speculation was so rife that numerous working days were lost due to workers "playing the market".

Externally, following the relaxation of exchange controls in 1986, the NT\$ started to appreciate rapidly, rising around 50% against the US\$ up to the end of 1989 (Chart 5). The appreciation of the NT\$ helped dampen the inflationary pressures of broad money supply growth in excess of 20% between 1983-87 (Chart 6), and rising wages and land prices. Wholesale prices actually fell over 1989-90 (Chart 7) while the CPI rarely exceeded 5%. Nevertheless, the average annual growth in the CPI of 4.4% over 1989-90 contrasts with an average increase of only 0.9% per annum over 1982-88.

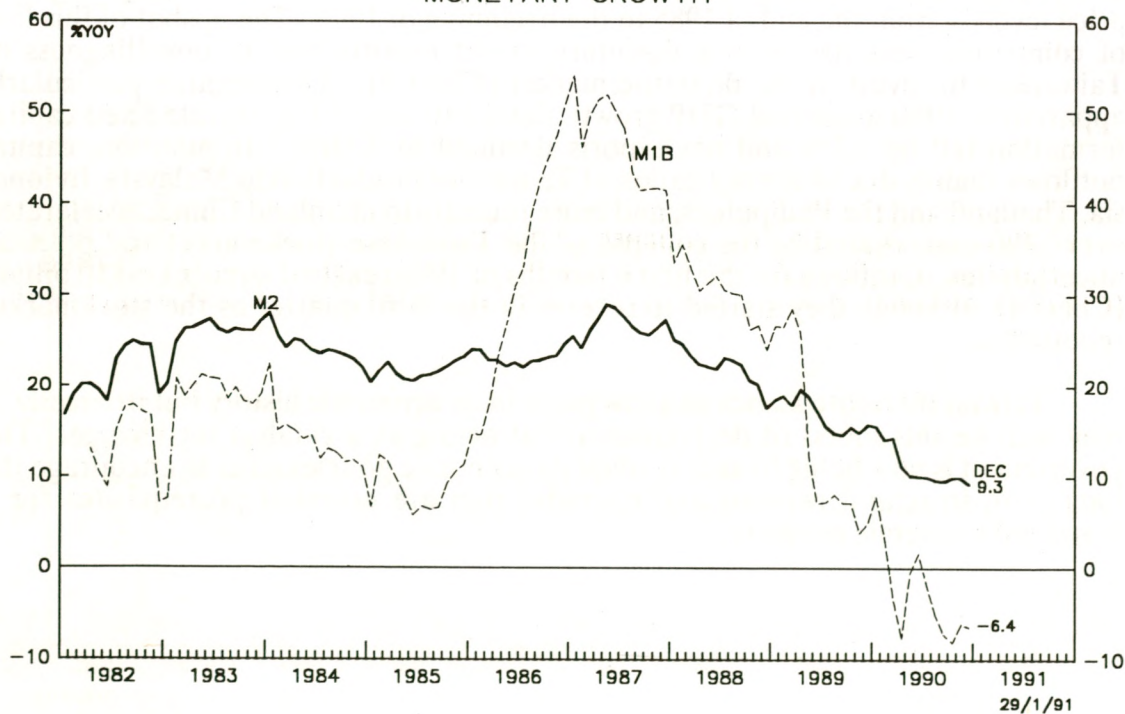
The combination of rising internal and external costs produced a gradual loss in competitiveness. The predicted NT\$/US\$ exchange rate using purchasing power parity (PPP) suggests that since the end of 1986 the NT\$ has been significantly overvalued against the US\$. As a result, export growth to the US has slowed and the US now accounts for 33% of total exports compared to almost 50% in 1986. However, Taiwanese exports have also become more expensive compared to those of many of its other major competitors. This is reflected by the upward movement in the index of the real effective exchange rate (REER) -- that is adjusted for trade weightings and price levels -- from the end of 1985 to the beginning of 1990. The upshot of this loss of competitiveness has been a downturn in net exports and an unwillingness of Taiwanese to invest in the domestic market (Chart 8). This became particularly apparent in 1990 when real GDP growth slowed to only 5.1%, private fixed capital formation fell by 4.7% and net exports declined by 12.0%. In addition, capital outflows, mainly due to the relocation of Taiwanese production to Malaysia, Indonesia, Thailand and the Philippines, and more recently to mainland China, accelerated over 1990 exacerbated by the collapse of the Taiwanese stockmarket and political uncertainties. Outflows for the first 6 months of 1990 reached almost US\$10 billion (Chart 4), although they started to reverse in the third quarter as the stockmarket rebounded.

Taiwan therefore stands at a low point in its economic history but ironically, it may well be this mood of despondency that acting as a catalyst for change. The government is now being forced to adapt its economic policies so as to encourage the long term structural reforms and upgrades that are essential prerequisites for a sustained economic recovery.

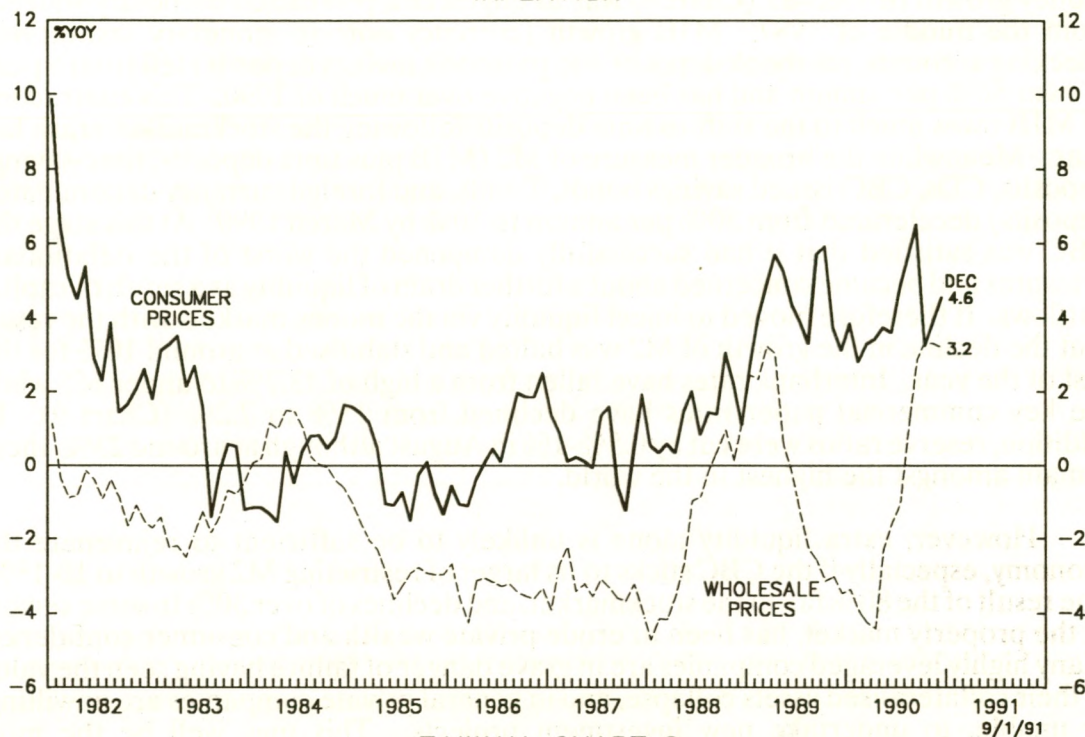
TAIWAN: CHART 5
THE NT\$/US\$ REAL EFFECTIVE EXCHANGE RATE AND VERSUS THE US\$



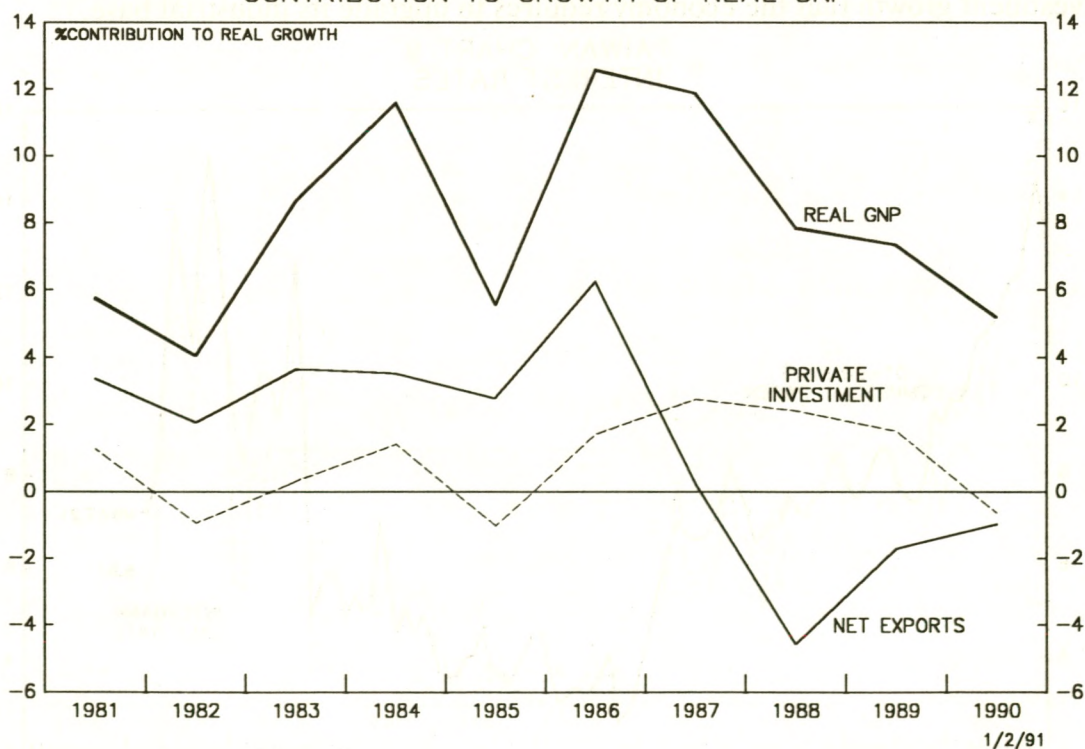
TAIWAN: CHART 6
MONETARY GROWTH



TAIWAN: CHART 7
INFLATION



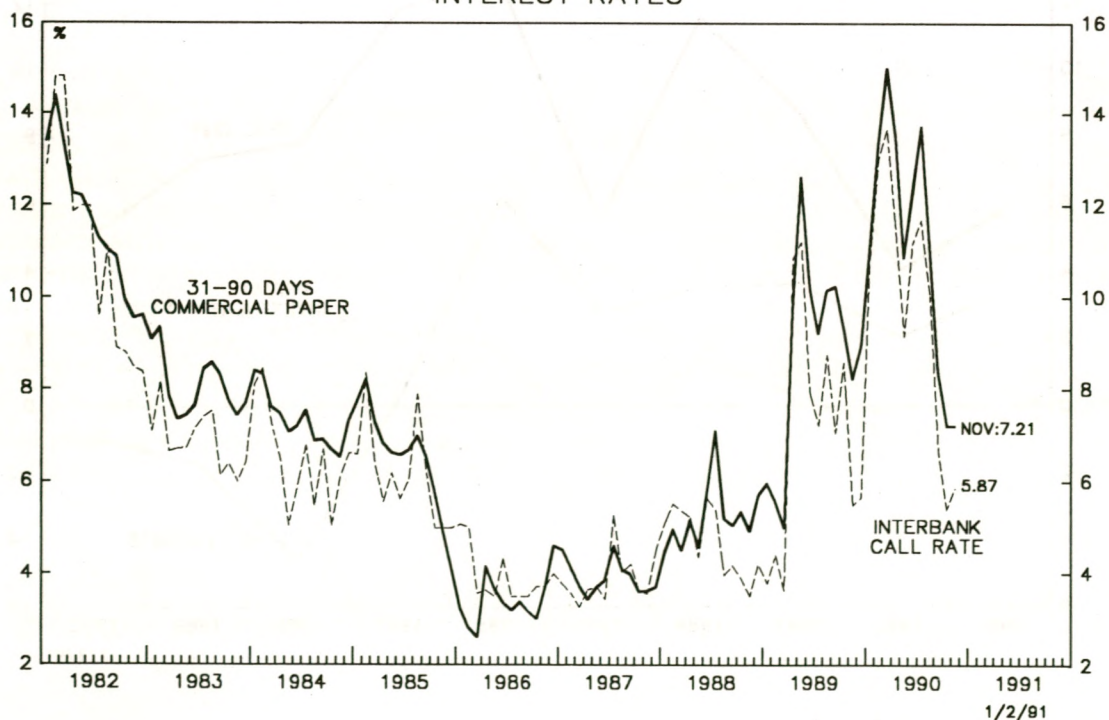
TAIWAN: CHART 8
CONTRIBUTION TO GROWTH OF REAL GNP



The Central Bank of China's (CBC) response to the aforementioned excess money growth of 1983-87 (Chart 6) was to engineer a protracted monetary squeeze from the middle of 1987. M1B growth (currency outside monetary institutions, checking accounts, passbook deposits and passbook savings deposits) fell from a peak of over 50% per annum and has been negative over much of 1990. This contraction of M1B owes much to the shift to time deposits following the stockmarket crash last year. Meanwhile the broader measure of M2 (M1B plus time deposits, time-savings deposits, CDs, CBC-issued savings bonds, T-bills, and foreign currency denominated deposits) decelerated from 30% per annum to 10% by March 1990. At this stage the CBC was satisfied that it had successfully dampened the worst of the inflationary pressures and became concerned about a further drain of liquidity as a result of capital outflows. It therefore moved to inject liquidity via the money markets with the result that the decline in the growth of M2 was halted and stabilised at around 10% for the rest of the year. Interbank rates have fallen from a high of 13.7% to under 6% while the key commercial paper rates have declined from 15% to 7.2% (Chart 9). In addition, reserve ratios were cut by 0.5%-1% in August although at around 23%, these remain amongst the highest in the world.

However, extra liquidity alone is unlikely to be sufficient to rejuvenate the economy, especially if the CBC sticks to its target of restricting M2 growth to 10-15%. The result of the 80% fall in the stockmarket, and declines of over 30% in some sectors of the property market, has been to erode private wealth and consumer confidence. Many highly leveraged companies are in grave danger of failure having seen the value of their collateralised assets collapse, and in general private companies are unwilling, or unable, to undertake new investment projects. This may well be the most worrisome aspect of the economic slowdown as it is precisely a recovery in fixed investment growth that the economy requires to upgrade its industrial base.

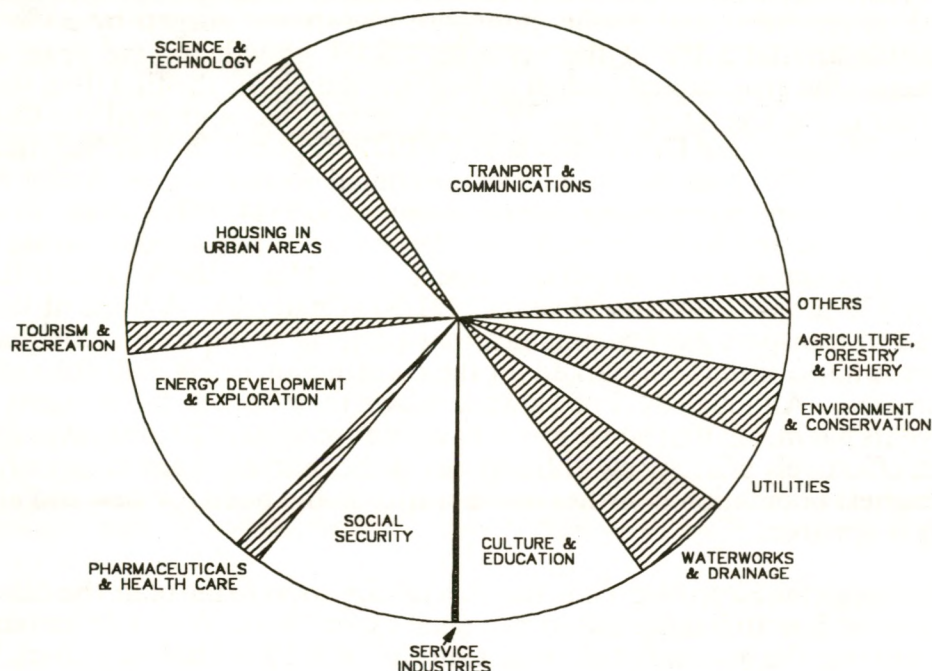
TAIWAN: CHART 9
INTEREST RATES



Fortunately, the government seems to have realised that it will be necessary for the public sector to take the lead in stimulating fixed investment growth, in contrast to many years of reluctance to contribute substantially to the nation's capital stock. To this end, government and public enterprise investment surged by 33% in 1990, contributing around 3.4% of the economy's 5.1% growth for the year, and as a consequence the government budget moved into deficit for the first time since 1986. Furthermore, the Executive Yuan, Taiwan's cabinet, has approved the Council for Economic Planning and Development's (CEPD) proposed "6-year National Development Plan". This plan targets an average annual economic growth rate of 7% for the next 6 years and a per capita annual income of US\$14,000 by 1996. In addition, inflation is projected to fall from 5% in 1991 to 3.5% per annum during 1992-96. However, perhaps the most important aspect of the plan is the NT\$8.2 trillion to be spent on 779 projects over fiscal years 1991-96 (Chart 10). A third of this sum is allocated to transport and communications projects to improve inadequate infrastructure, while a fifth is earmarked for the construction of 900,000 units of housing in urban areas. Although 80% of Taiwanese own their homes, the property boom of recent years has meant that house prices have risen to around 20 times average annual salaries, effectively pricing new entrants out of the market. Taiwan already has one of the highest population densities in the world, so the need for new and affordable housing is apparent.

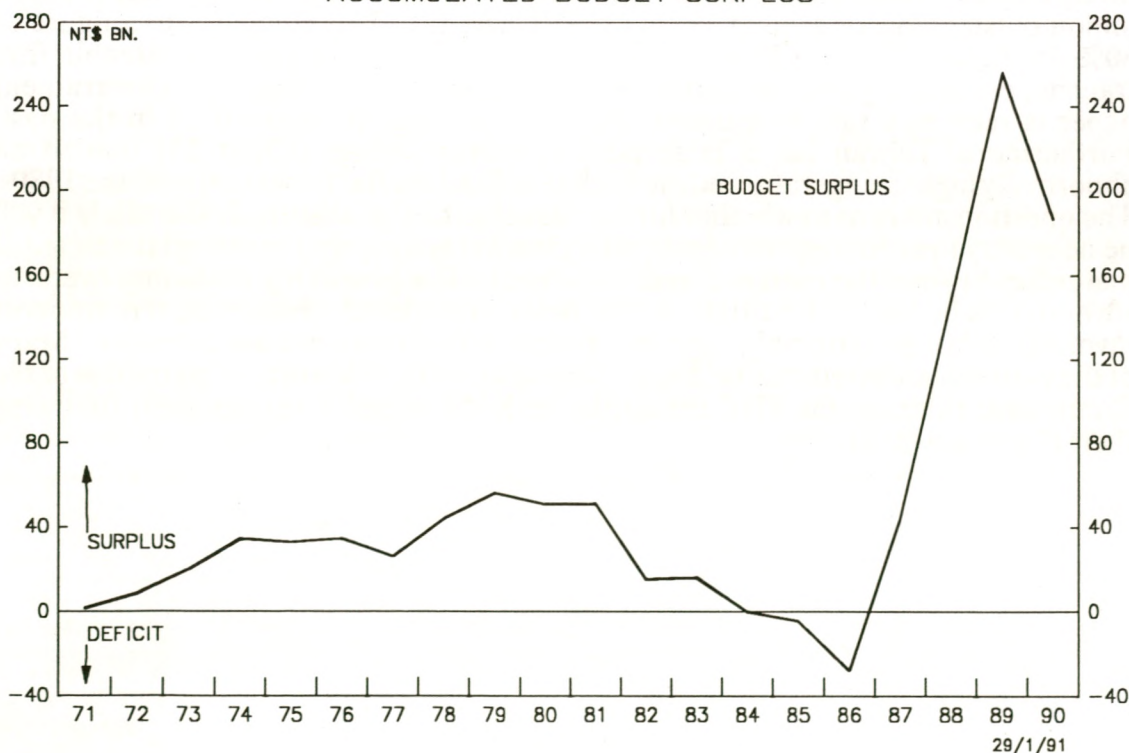
Although the Executive Yuan has given its approval to the plan, the debate is still continuing on how to finance this incremental expenditure. A certain amount can be met by tapping the accumulated budget surplus of NT\$190 billion (Chart 11) while extra revenue can be raised by privatising state-run enterprises. However, a large part of the expenditure -- the CEPD estimates NT\$6.4 trillion -- will have to be met through bond financing. Previous surpluses have meant that the government has rarely needed to issue substantial amounts of bonds, and today there are only NT\$132 billion outstanding, or around 3% of GDP (Chart 12). This compares to a figure of 60% for Japan. There is little doubt that the market could absorb a sizeable first tranche, especially given the current lack of stockmarket confidence. Government paper is seen as a safe investment and has been eagerly snapped up in the past. Furthermore, Taiwan has a huge pool of excess savings (Chart 13) due to an abnormally high savings ratio and the decline in fixed capital formation over the 1980s. The question arises as to whether further tranches can be absorbed. Certainly it will be necessary to encourage more secondary market activity and to extend the range of maturities beyond the current 5 year maximum. The possibility of issuing overseas sovereign debt for the first time is also being considered. However, the amounts involved, although extremely large by Taiwanese standards, are not excessive. Many of the worries expressed may be due to either fear of the unknown, or memories of the Communist rulers of the PRC defaulting on KMT issued sovereign debt following their rise to power in 1949.

TAIWAN: CHART 10
BREAKDOWN OF 6-YEAR DEVELOPMENT PLAN PROJECT
FISCAL YEARS 1991-96

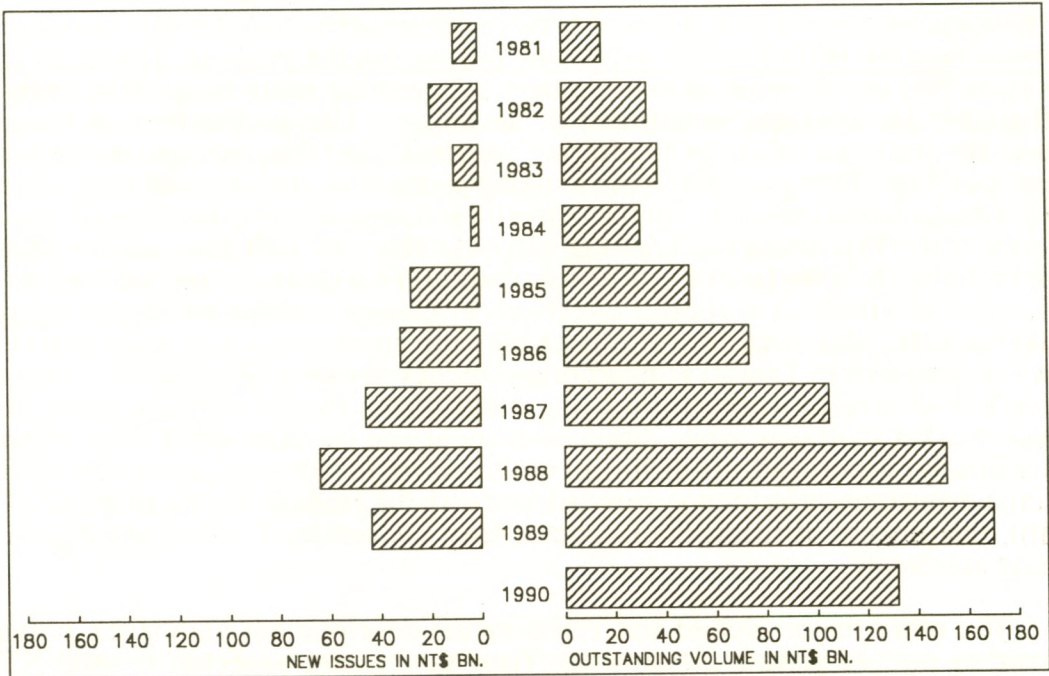


TOTAL PROPOSED EXPENDITURE = NT\$ 8.2 TRILLION

TAIWAN: CHART 11
ACCUMULATED BUDGET SURPLUS

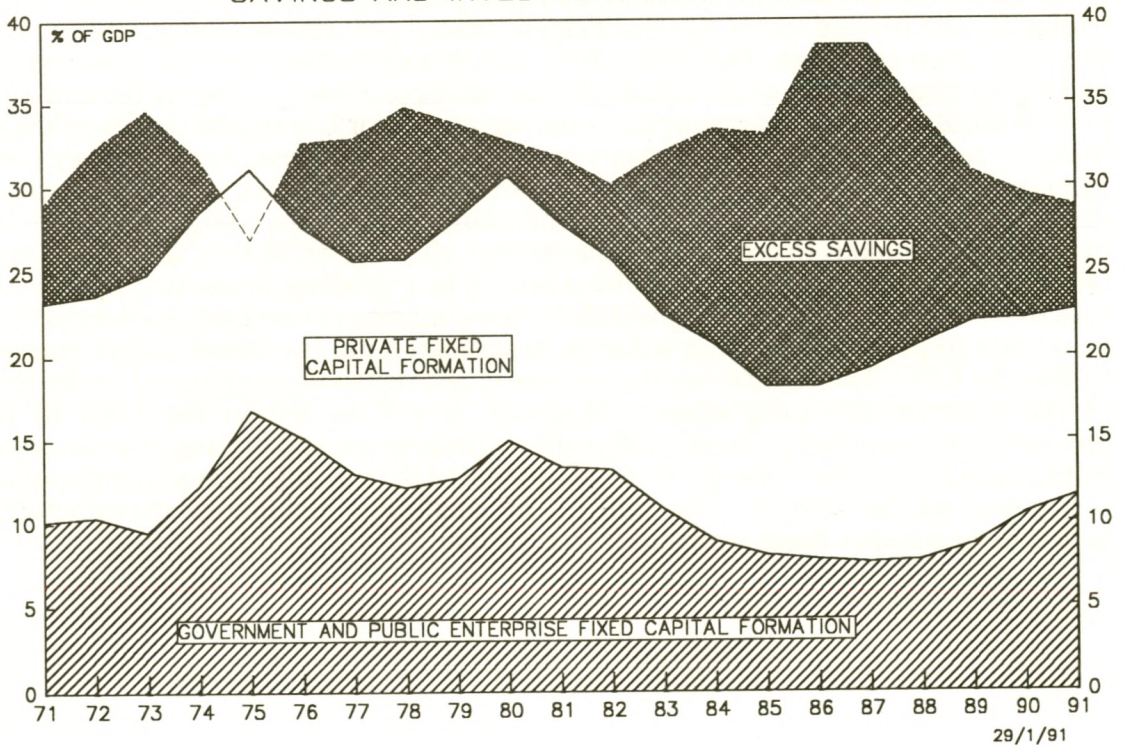


TAIWAN: CHART 12
ISSUES OF GOVERNMENT BONDS



30/1/91

TAIWAN: CHART 13
SAVINGS AND INVESTMENT AS A % OF GDP



29/1/91

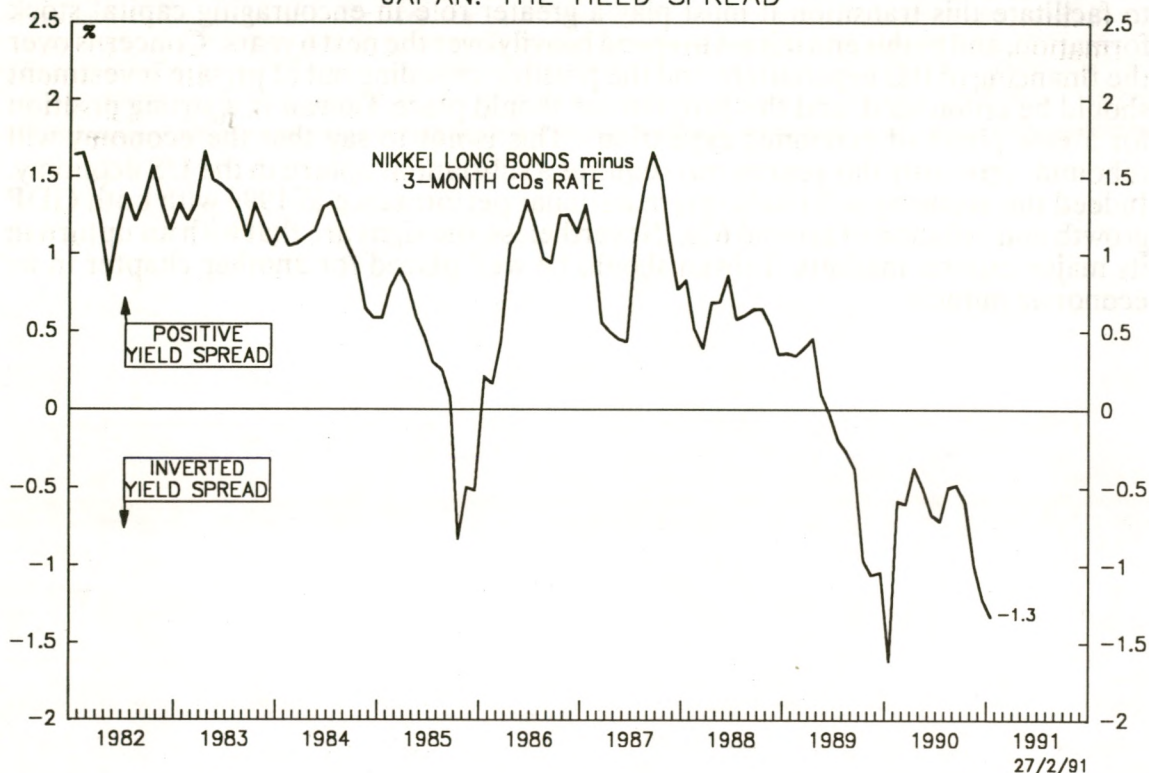
Various other reservations have been expressed concerning the development plan. There are doubts that the public sector has the ability to implement the plan properly due to a lack of expertise and an inefficient bureaucracy. Further reform of the political system is required as well as more deregulation and liberalisation in order to encourage the private sector to become involved in the projects. However, there are signs that the investment environment is becoming more hospitable while the enthusiasm for overseas investment is declining. The government is trying to encourage potential investors by offering tax breaks and duty exemptions on investment spending. Deregulation in the banking sector is continuing and entry barriers are gradually being lowered. Similarly, overseas investors are to be allowed to invest directly in the Taiwanese stockmarket, although this may well have been a decision taken reluctantly in the face of a collapsing market. Foreign investors and bankers will certainly find it difficult to operate effectively in Taiwan's unique and highly interpersonal markets. Measures have also been taken to improve law and order and clamp down on activities in Taiwan's unauthorised money markets. Restrictions governing the inflow of foreign workers are being eased which should alleviate some of the labour market shortages, while direct investment and contacts with China, although not officially encouraged, are no longer outlawed. In the long run, closer ties with the mainland must surely be the way forward, and with the gradual demise of the KMT old guard, the process of reconciliation on at least economic, if not political grounds, should accelerate.

The other major area of concern over the development plan is the potential "crowding-out" of private investment. Total savings are expected to total NT\$13 trillion over the next 6 years and it is argued that under the present proposals, only NT\$4.5 trillion will be available for private investment. However, only 60% of the NT\$8.2 trillion is currently allocated to capital spending, the rest being reserved for government current account spending and land purchases. This leaves almost NT\$8 trillion for the private sector, to which can be added past excess savings and the vast pool of foreign exchange. Inevitably there will be a certain element of crowding out and higher interest rates could ensue if the private sector has to compete for a smaller pool of funds. In addition, competition for private sector labour and land would also intensify perhaps adding to inflationary pressures. Nevertheless, these fears are once again probably overplayed. The structure of Taiwanese industry combined with a short term, mercantilist, profit-driven mentality implies that large scale private investment is unlikely to occur. Taiwanese firms will, in general, tend to remain small family concerns and are unlikely to invest heavily in upgrading production facilities or research and development. They will therefore continue to lose competitiveness and be unable to produce the large volumes demanded from the newer target markets such as the EEC. This is not to say that private investment will not rebound on the back of the government's programme. However, it will be left in the main to the government to encourage more foreign direct investment and improve the country's infrastructure, in order to foster the development of the key high technology manufacturing and service sectors. The shift of the small, low technology manufacturing concerns to cheaper bases overseas is irreversible.

FORECAST: Taiwan is embarking on a process of structural change from a country producing primarily cheap manufactured goods for export, to a more developed high technology and service based economy. The government seems to have realised that to facilitate this transition it must play a greater role in encouraging capital stock formation, and to this end it is set to spend heavily over the next 6 years. Concerns over the financing of this expenditure and the possible crowding out of private investment should be unfounded, and this programme should place Taiwan in a strong position for a new phase of economic expansion. This is not to say that the economy will rebound vigorously this year as this requires a substantial upturn in the US economy. Indeed the economy will likely return a similar performance to 1990 with both GDP growth and inflation of around 6%. Nevertheless, the signs are that with an upturn in its major exports markets, Taiwan should be well placed for another chapter in its economic miracle.

JAPAN: THE MONETARY SQUEEZE AND INTEREST RATES

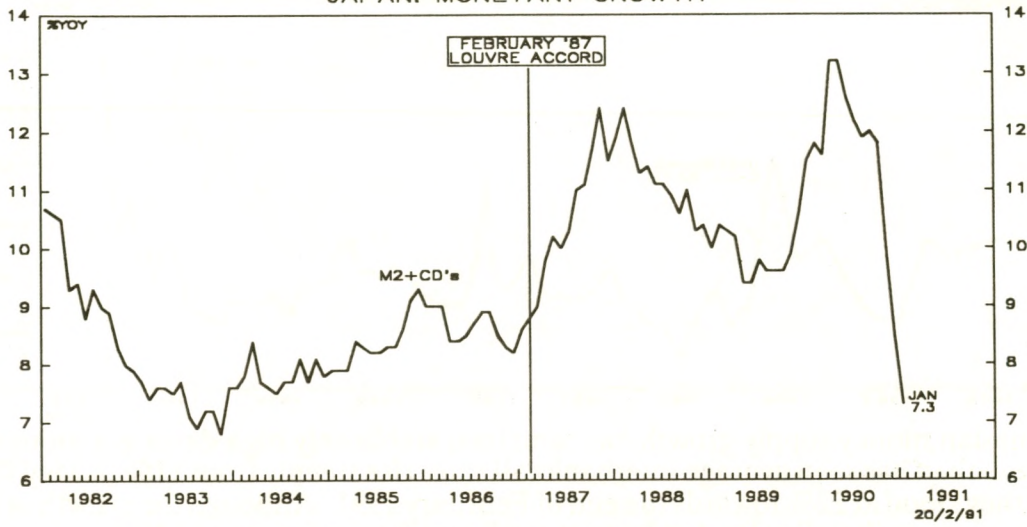
CHART 1
JAPAN: THE YIELD SPREAD



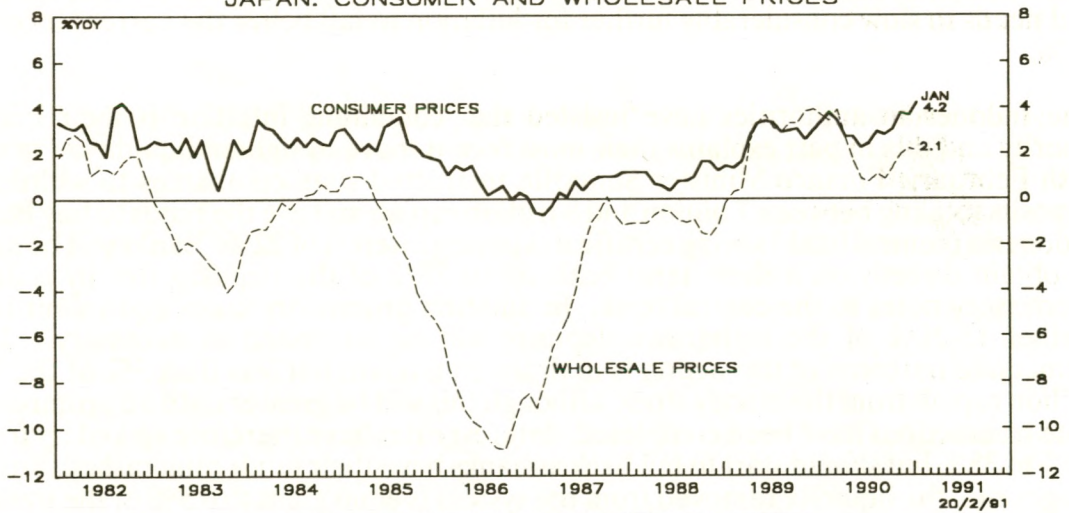
Since October 1990 the yield curve has become more steeply inverted (Chart 1). The upward trend in money stock growth was reversed in June of the same year leading in January 1991 to the lowest growth rate in eight years (Chart 2 upper panel).

The steeper inversion of the yield curve reflected two factors. Firstly the rise in short term interest rates engineered by the BOJ anxious to reverse the rapid expansion of bank loans and discounts which took place between Q.3 1989 and Q.3 1990. The official discount rate rose over twelve months (February 1990 to February 1991) by 175 basis points with the 3 month CD rates rising over the same period by 113 points. Secondly, Japanese government bond yields initially rose by 166 points from February 1990 to September but then fell by nearly 240 basis points to February 1991, depending which benchmark bond yield is used. One reason for this decline might have been the fact that the bond market, particularly towards the end of 1990, had already discounted a fall in inflation despite the almost continuous growth of the CPI since August 1990 (Chart 2 middle panel). The recent succession of indicators such as housing starts and industrial production pointing towards a slowdown in the economy may well have strengthened the conviction that the next move in short term interest rates would be downward. The successful and swift conclusion of the Gulf War, which now guarantees no substantial increases in the price of oil, may also bring nearer further drops in US interest rates. Unless, however, there is firm evidence of inflation in Japan slowing down, the BOJ will not relax its policy. Given the close relationship between the PE and bond yields (Chart 2, lower panel) the equity market cannot expect, for the time being, a boost from developments in bond markets.

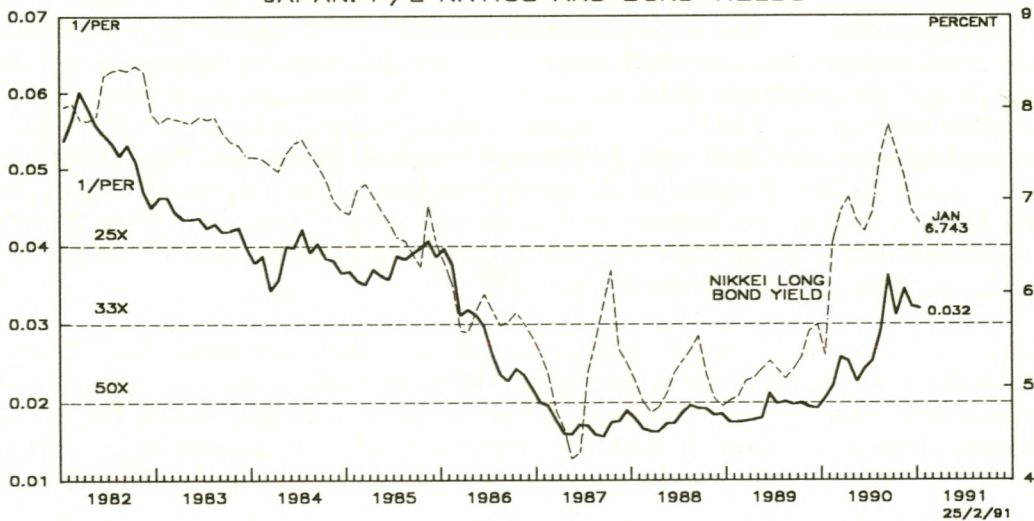
CHART 2
JAPAN: MONETARY GROWTH



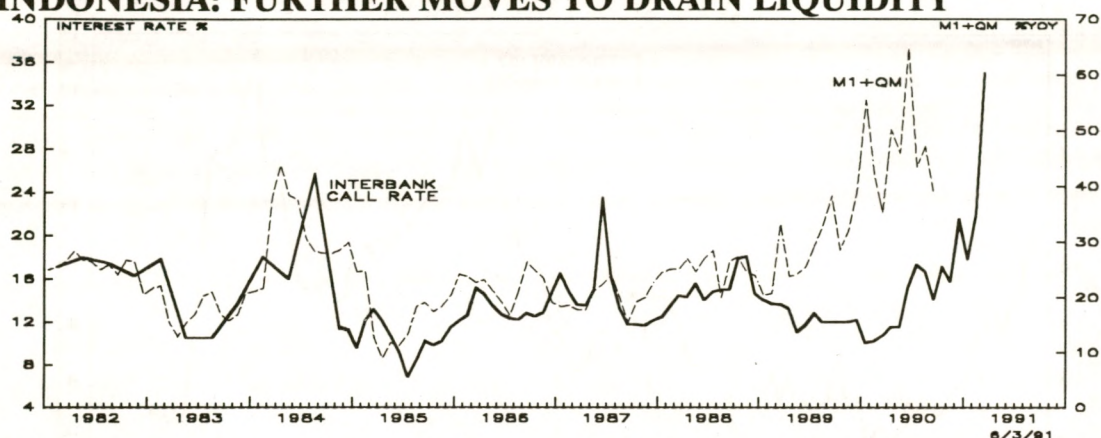
JAPAN: CONSUMER AND WHOLESALE PRICES



JAPAN: P/E RATIOS AND BOND YIELDS



INDONESIA: FURTHER MOVES TO DRAIN LIQUIDITY

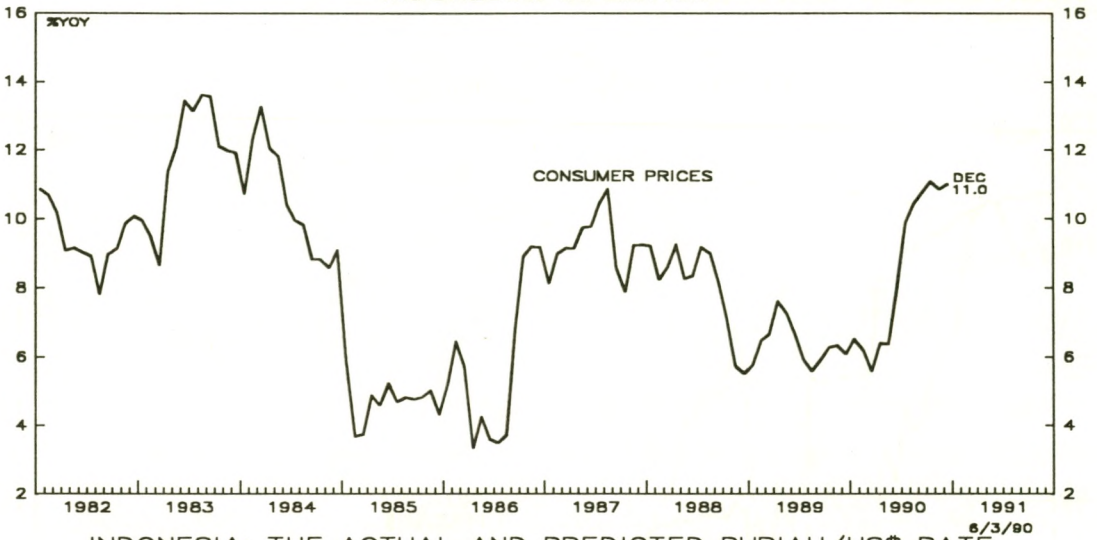


Indonesian money supply growth has remained stubbornly high despite a monetary squeeze than has seen average interbank call rates rise steeply from 11% in May 1990 until they stood at 22% towards the end of February 1991. Although the growth of M1 + Quasi money has decelerated from its peak, it still remains around 40% per annum and needs to slow considerably further for inflation to fall below the current level of 11%.

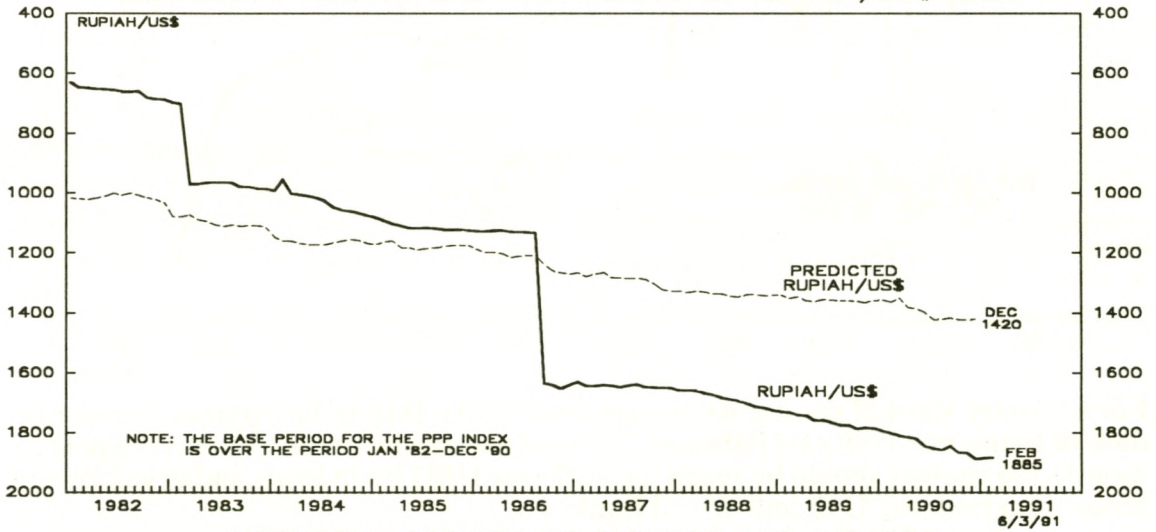
The Indonesian authorities have insisted that containing inflation is their major priority and this in part explains their most recent move to tighten liquidity. On the 27th February, Finance Minister Sumarlin instructed state companies to withdraw deposits totaling between 7 billion and 8 trillion rupiah and use the funds to buy Bank Indonesia (central bank) saving certificates paying interest of 22%. Banks will be able to obtain directly on a short term basis up to 75% of the deposits lost by selling promissory notes to the central bank. In addition promissory notes equivalent to a further 15-20% of the withdrawn deposits will be auctioned as necessary. The immediate outcome of this action is to drain an amount not less than 5% of the 7-8 trillion rupiah from the money stock, although this will be greater until all promissory note transactions have been completed. Interest rates have therefore spiked up from 22% to 35% but should start to fall back as banks have their funds replenished. In the longer run, the liquidity removed from the system is equivalent to 0.5% of the money stock and the central bank gains more direct control over a further 10%, adding to its ability to fight inflation. The second reason offered for this sudden policy move was that the government was concerned about mounting devaluation rumours which were causing people to switch out of rupiah and into US\$. Although the rupiah has been stable since the beginning of the year and remains undervalued vis-a-vis the US\$, the end of hostilities in the Gulf brought fears of lower oil prices and thus a worsening current account deficit. Imports continue to grow strongly while non-oil exports have slowed along with the economies of Indonesia's major markets. It is therefore estimated that the current account deficit, presently forecast at 2.9% of GDP for 1991/92, could balloon to almost 5% of GDP.

By draining liquidity and thereby raising interest rates, the government has attempted to attack the twin problems of rupiah speculation and excess money supply growth. The result has been to effectively bring a halt to the former and should be reflected in a deceleration of the latter. In addition, imports should slow and savings should rise. However, further measures may be necessary to reduce money supply growth to a level at which inflation can start to fall significantly.

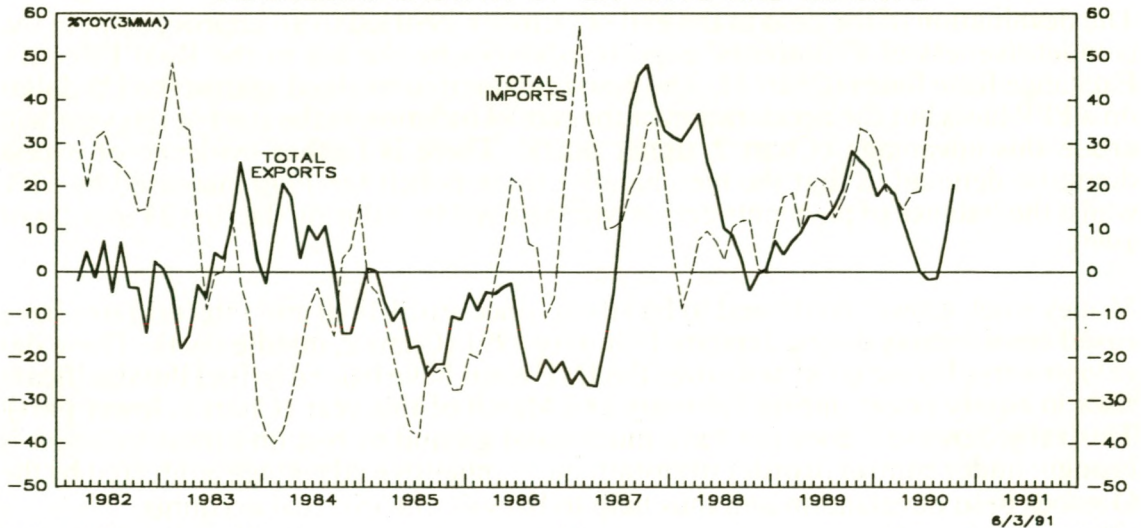
INDONESIA: INFLATION



INDONESIA: THE ACTUAL AND PREDICTED RUPIAH/US\$ RATE

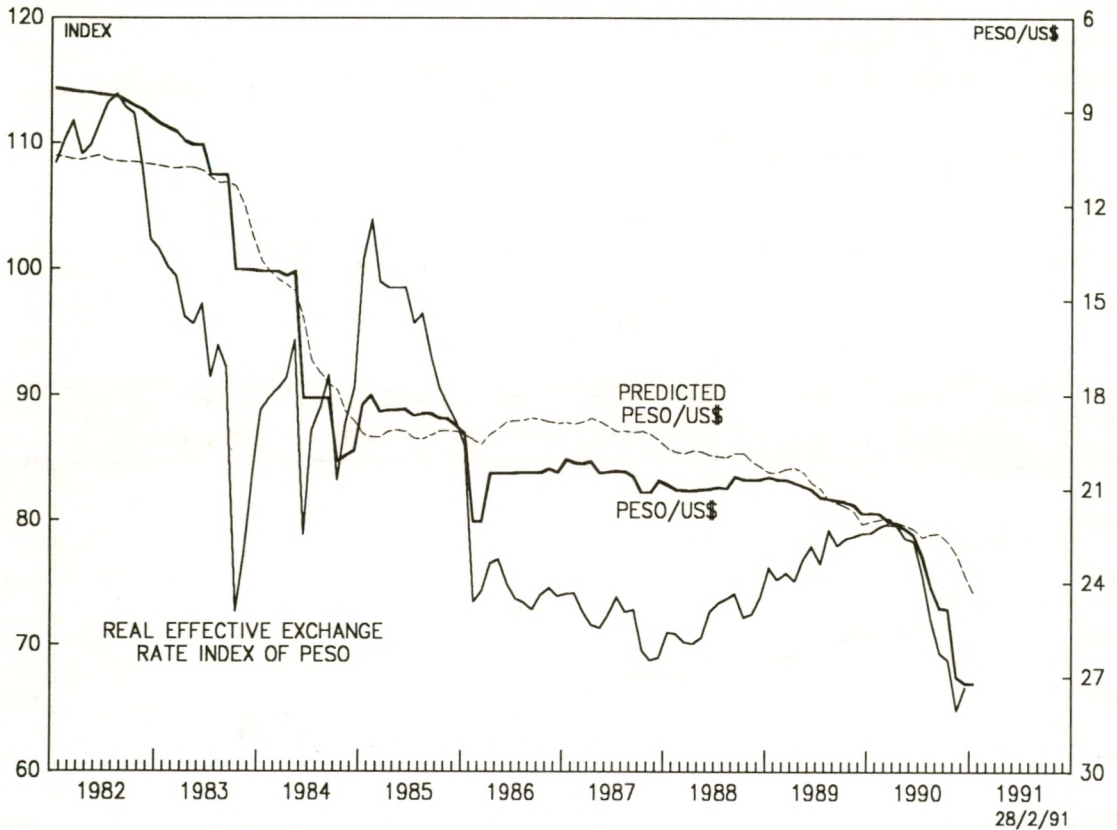


INDONESIA: GROWTH OF EXPORTS AND IMPORTS



PHILIPPINES: CAUTION ADVISED

CHART 1
THE PHILIPPINES: EXCHANGE RATES

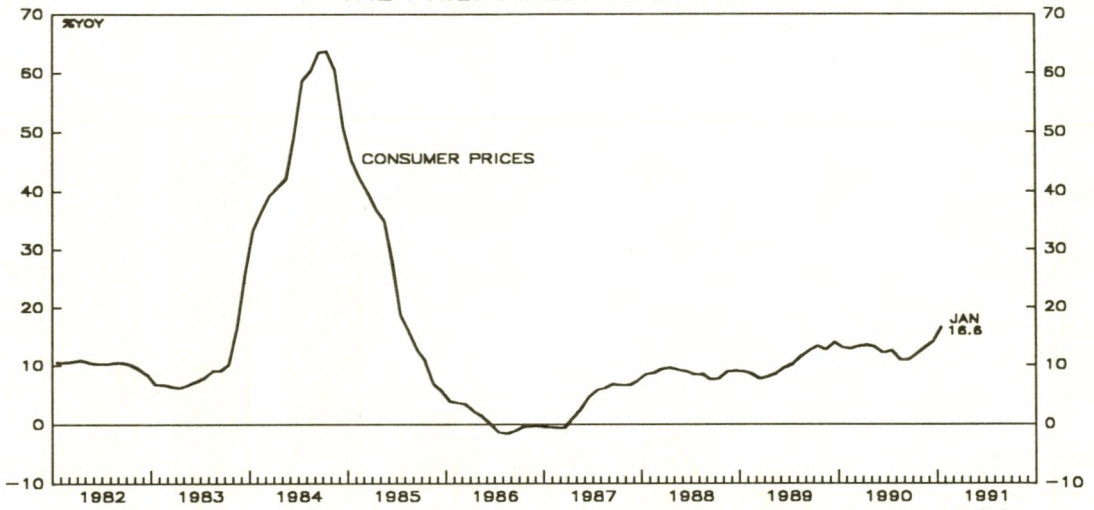


For a country short of good news, the approval by the IMF of Philippines' Memorandum of Economic Policy on February 20th was a welcome break. Within the next 18 months the country should be receiving well over US\$1 bn in loans and development funds from both the IMF and World Bank.

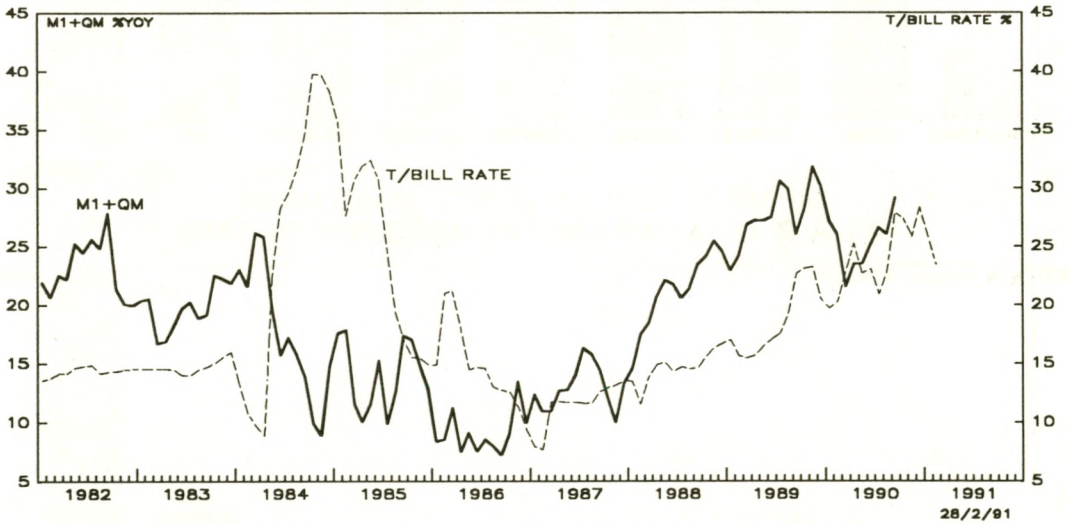
The devaluation of the peso at the end of October 1990 led to an improvement in the competitiveness of Philippines' exports as shown by the fall in the Real Effective Exchange Rate Index (Chart 1). The peso remains undervalued against the US dollar on a PPP basis but the acceleration of the rate of inflation at the start of this year will erode this advantage (Chart 2, upper part). There is further evidence of excess domestic demand in that the merchandise trade deficit for 1990 increased by 54% whilst the balance of payments deficit widened by 146% during the first 11 months of 1990.

Money stock growth continued to be strong since April 1990 and interest rates have eased considerably during January-February 1991 (Chart 2, middle part). These developments plus the good news over the IMF loans have helped to fuel the significant rises in equity prices during February and March of this year (Chart 2, lower part). This rally, however, does not have much solid ground to rest on unless inflation is brought under control in order to sustain the competitive advantage conferred by the October peso devaluation and thus help to balance the external accounts.

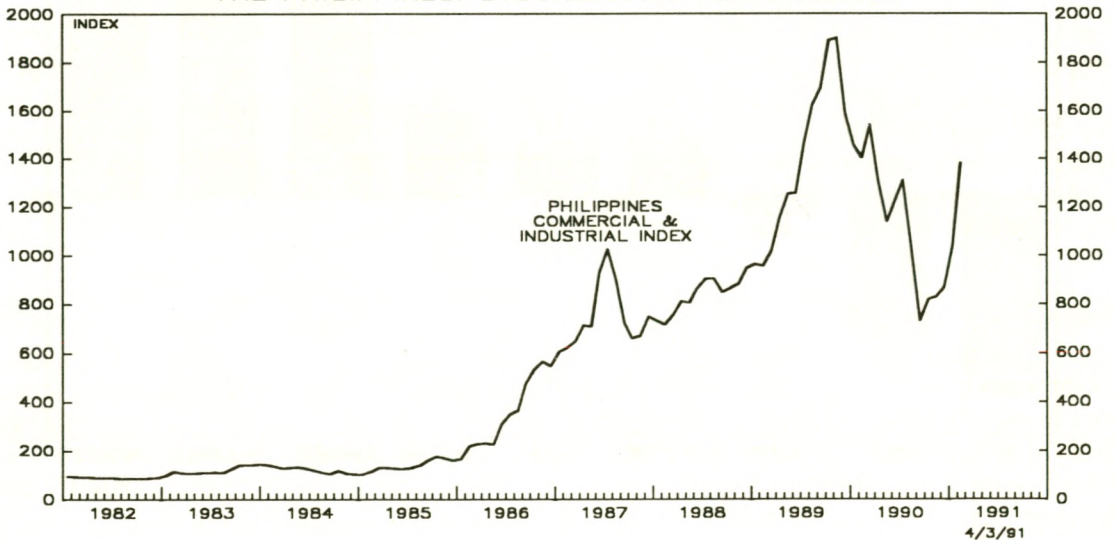
CHART 2
THE PHILIPPINES: INFLATION



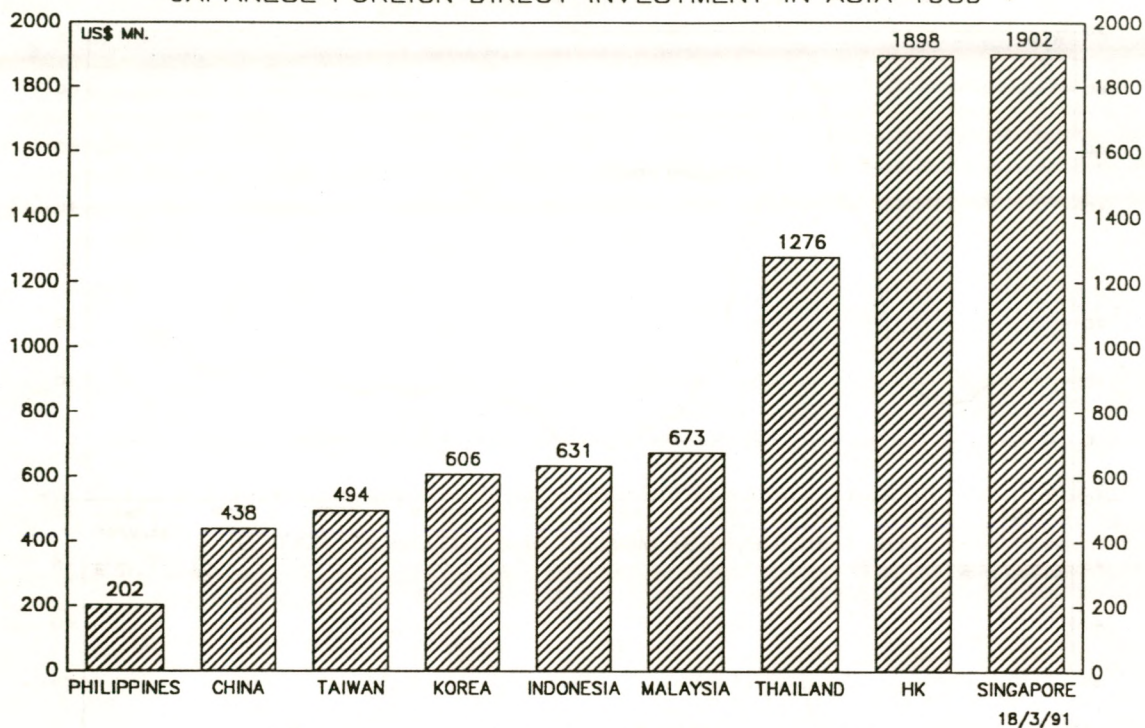
THE PHILIPPINES: MONEY AND INTEREST RATES



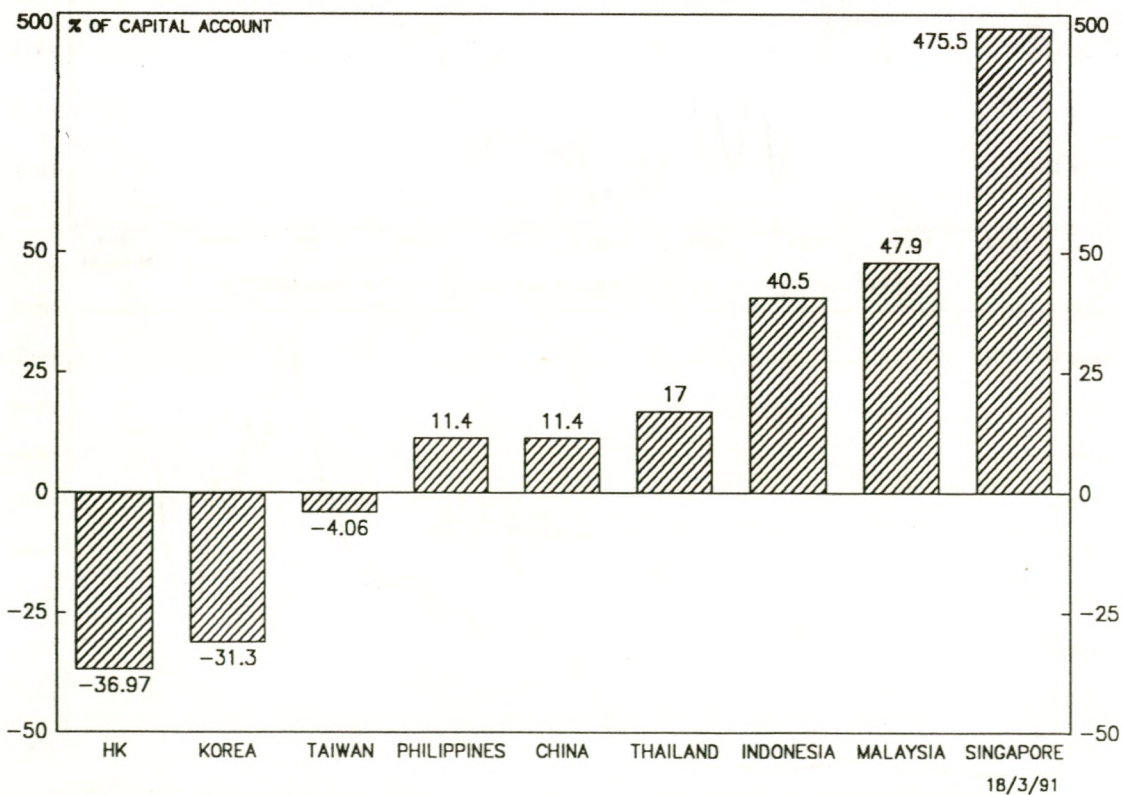
THE PHILIPPINES: STOCKMARKET PERFORMANCE



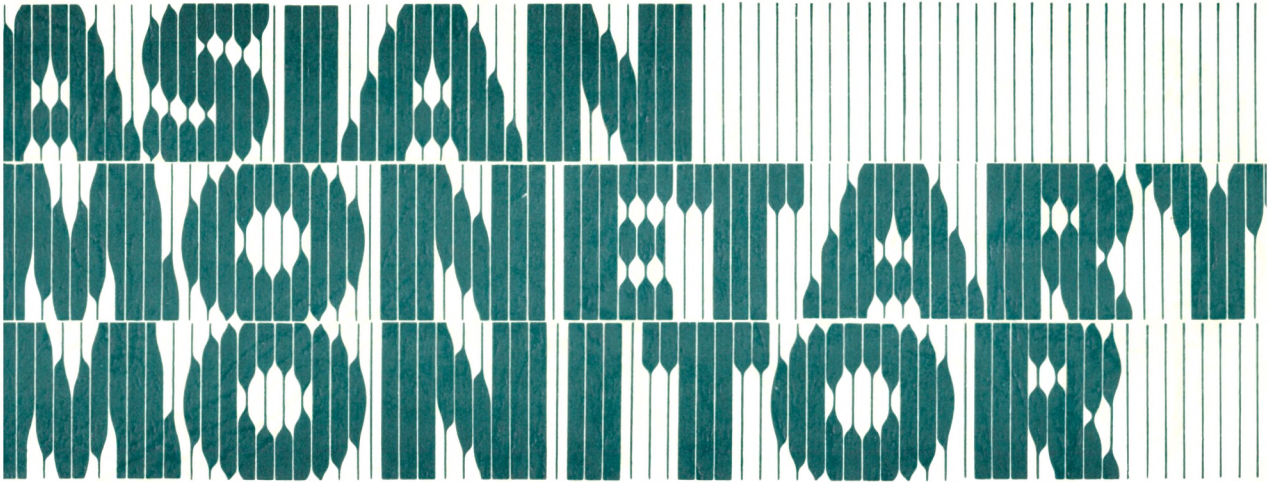
JAPANESE FOREIGN DIRECT INVESTMENT IN ASIA 1989



JAPANESE FOREIGN DIRECT INVESTMENT AS A % OF ASIAN CAPITAL ACCOUNTS IN 1989







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HONG KONG

THE PROBLEM OF CPI INFLATION - MONETARY OR STRUCTURAL?

Introduction.

Hong Kong has experienced numerous different monetary standards during its 150-year history. In the early years of the colony up to 1935 Hong Kong was on the silver standard. From 1935 to 1972 Hong Kong was on a sterling standard, i.e. the price of Hong Kong dollars was fixed in terms of Sterling. However, in 1967 when the dollar-sterling rate was changed from \$2.80 to \$2.60 the HK\$-Sterling rate was also changed from HK\$ 16 per pound to HK\$ 14.5 per pound. From 1972 to 1974 the Hong Kong dollar was fixed to the US\$, i.e. Hong Kong was on a US\$ standard. Then in November 1974 the HK currency was floated, and it remained floating, though with periodic official intervention, until October 1983. Finally, after a period of severe instability culminating in a run on the currency in September 1983, the currency was repegged to the US dollar in October 1983, and it has remained firmly pegged to the US dollar for the past 7 1/2 years.

Historically the overall inflation rate in Hong Kong has been determined by the monetary standard. Under the sterling standard of the post-war years (to 1972) Hong Kong's inflation was broadly similar to that in the UK. (For an explanation of this statement and qualifications see AMM Vol. 6, No. 6 November-December 1982 pp. 40-52, especially "How the Automatic Adjustment Mechanism Worked: Hong Kong 1952-74.") Under the floating exchange rate from 1974 to 1983 the inflation rate in Hong Kong was in a sense independent of inflation elsewhere, though its cyclical pattern was broadly determined by the business cycle abroad, which in turn influenced credit creation and hence money growth in Hong Kong. Following the introduction of the linked rate system for the Hong Kong dollar in October 1983 the inflation rate slowed down (after an initial period of adjustment to the earlier depreciation of the currency), and in the years 1985-87 Hong Kong's CPI appeared to converge to the inflation rate being experienced in the United States. In AMM Vol. 9 No. 4, July-August 1985, "Adjusting to the Link" we concluded: "Hong Kong's domestic prices have now adjusted under the linked rate system to price levels in the US in the sense of attaining levels which are compatible with equilibrium in the balance of payments. In future the overall price level in Hong Kong will fluctuate around the price level in the US, keeping Hong Kong's economy roughly competitive with the US at the given exchange rate. Differences in inflation rates will surely emerge over the short to medium term, but over time these will be small (where they are not due to different composition of the indices under comparison)".

In the light of the clear divergence of Hong Kong's CPI and the US CPI since 1988-89, that conclusion must now be revised, or at least refined. For example, in the

year to December 1990 the average of Hong Kong's three CPI indices rose by 11.3% over December 1989, compared with a rise of 6.2% in the US CPI over the same period. A more accurate statement of the relation between overall price levels in the two economies (so long as they are linked by a permanently fixed exchange rate) would be: The US dollar standard or fixed rate link to the US dollar operates to adjust traded goods prices (rather than domestic prices) in Hong Kong to traded goods prices in the USA. In future traded goods prices in Hong Kong will fluctuate around traded goods prices in the USA, keeping Hong Kong's economy roughly competitive with the US at the given (7.80) exchange rate. Differences in CPI-inflation (i.e. inflation in non-traded goods) will surely emerge, either in association with faster growth of productivity in Hong Kong than in the US or with structural changes in the Hong Kong economy (i.e. changes in the composition of the GDP). Large changes in productivity or in the composition of output in Hong Kong relative to the USA will exacerbate such changes in Hong Kong's domestic (CPI) price indices, but CPI inflation will not necessarily undermine the territory's overall competitiveness provided that Hong Kong is shifting the composition of its output into areas where it retains a comparative advantage.

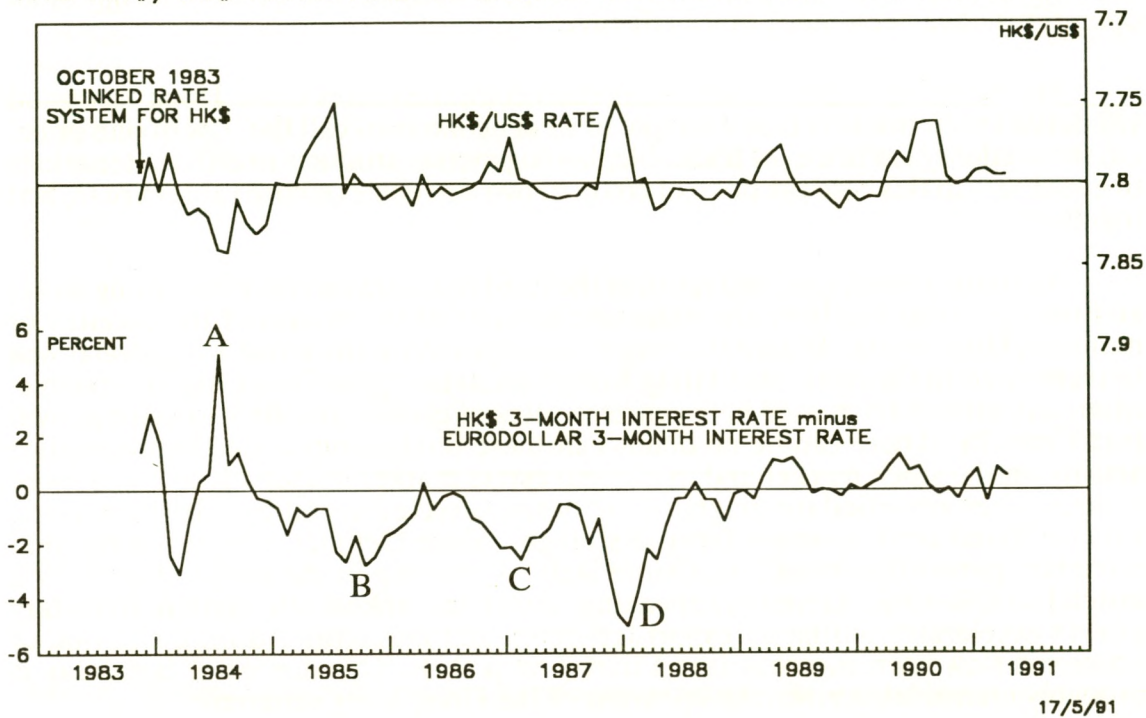
In this paper we will argue that, despite recent criticisms to the contrary, the US\$ standard is a sound and stable basis for Hong Kong's monetary system. The inflation which Hong Kong is currently experiencing will first be shown to be more a product of changes occurring in the economy than problems in the monetary system. Nevertheless various types of proposals have been put forward to deal with CPI inflation, so this paper goes on to examine the three main categories of proposal currently advocated in Hong Kong, namely: (1) Linking the Hong Kong dollar to a basket of currencies instead of to the US dollar alone; (2) Importing labour from abroad; and (3) Using fiscal policy to counter inflation. A full analysis of these proposals shows that they would not solve the CPI-inflation phenomenon. The conclusion is that Hong Kong's economy is undergoing a rapid, perhaps even a drastic period of structural change, but that any of the three proposed solutions either has costs which would outweigh the benefits (1), or is logically flawed, (2) and (3), when a complete analysis is performed, and therefore would not accomplish the desired result in any case.

Consequences of the Linked Rate System

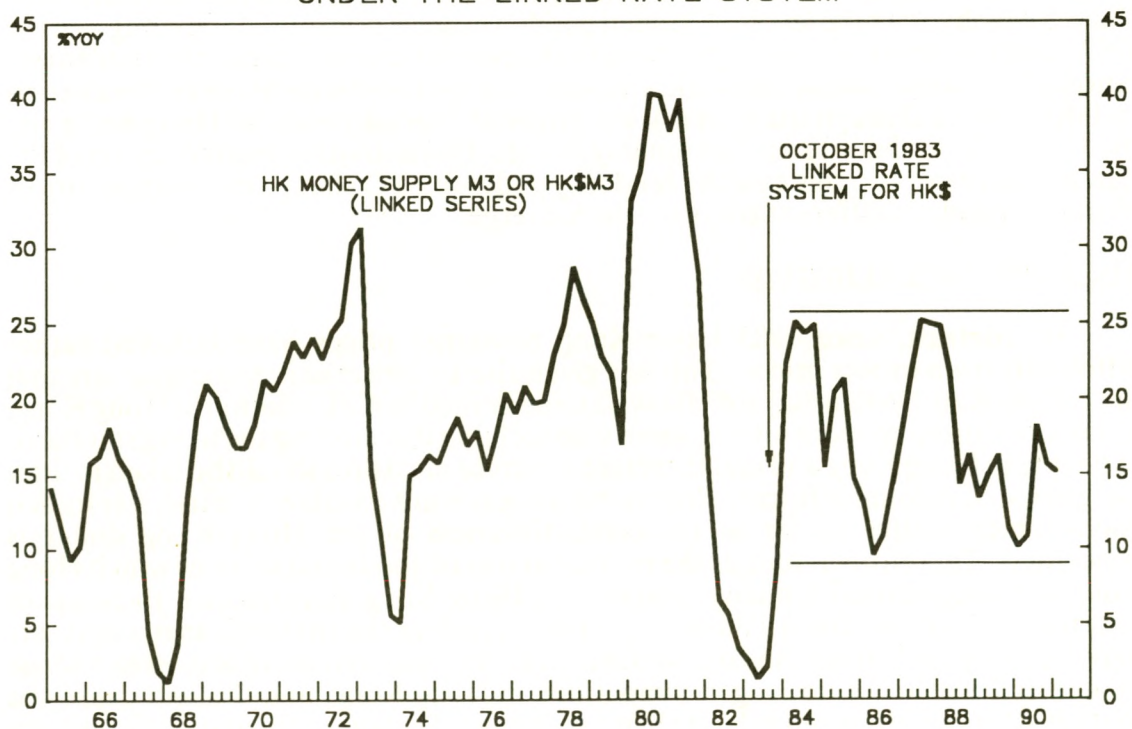
One of the more obvious results of the link between the Hong Kong dollar and the US dollar is to keep Hong Kong's money market interest rates closely in line with money market interest rates for the US dollar (see Chart 1). Occasionally there have been substantial deviations -- notably in July 1984 (A), in late 1985 (B), in December 1986/January 1987 (C) and December 1987/January 1988 (D) -- due to large inflows or outflows.

These deviations between HK\$ interest rates and US\$ interest rates occur either when there is an "internal drain" (i.e. a run on a bank in Hong Kong with depositors converting deposits to currency) or when there is an "external drain" (i.e. a speculative inflow or outflow of currency in anticipation of an upward revaluation or a downward devaluation of the Hong Kong dollar). Prior to 1988 these episodes threatened to become quite serious on account of the fact that the authorities had only partially implemented the pegged rate system. (By only granting convertibility of the Hong Kong dollar at 7.80 per US dollar to the banks and not to the public, the effectiveness of the link was significantly reduced.) However, since July 1988 these deviations have

HONG KONG: CHART 1
THE HK\$/US\$ RATE AND 3-MONTH INTEREST RATE DIFFERENTIALS



HONG KONG: CHART 2
HONG KONG'S MONEY SUPPLY HAS STABILISED
UNDER THE LINKED RATE SYSTEM



been much less serious because certain central banking mechanisms have been added to the government's armoury of monetary weapons and as a result official intervention operations have been much more effective.

The resulting alignment of money market interest rates in the Hong Kong and US dollar credit markets is an example of what economists call the "law of one price" i.e. the tendency for prices of tradeable, homogeneous products in different markets to equalise -- in this case the price of credit in two currencies whose values are locked together.

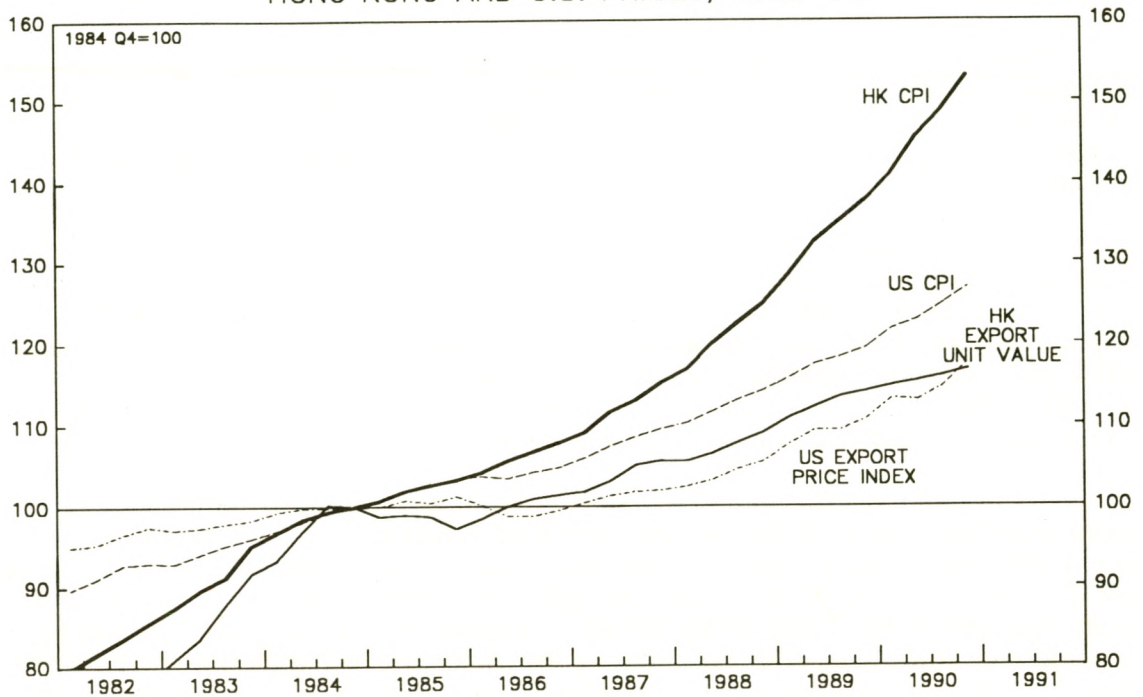
At another level, a second result of the fixed link between the Hong Kong dollar and the US dollar has been the enhanced stability of the growth of the quantity of money in Hong Kong. Before the pegged rate system for the Hong Kong dollar was implemented in October 1983 Hong Kong's monetary growth was highly unstable. Monetary growth fluctuated between zero rates of growth and 40% rates of growth (see Chart 2). There can be no doubt that these fluctuations added to speculative activity on the stock market and in the real estate market in Hong Kong, and more seriously they amplified the magnitude of business cycle fluctuations. In short, Hong Kong suffered from a severe form of stop-go. Since October 1983 it is clear that monetary growth has been much more stable -- varying in the range of 10%-25% instead of 0%-40%. Generally speaking, under the linked rate system, monetary growth accelerates during an export-led boom and decelerates during a period of economic slowdown overseas (see Chart 7 on p. 11). This degree of instability is probably unavoidable given the openness of the Hong Kong economy.

A third crucial and fundamental result of the Linked Rate System for the Hong Kong dollar has been to tie the price level of Hong Kong's exports (i.e. traded goods) to the level of internationally traded goods prices in the U.S. This is clearly shown in Chart 3 which shows the levels of "traded goods" (export) prices in Hong Kong and the USA, and the levels of consumer prices in the two economies. Since the implementation of the linked rate system (allowing one year for the effects of the currency crisis in 1983 to work through the system), the prices of "traded goods" in Hong Kong and the United States have remained roughly in line. This is another manifestation of the "law of one price" -- in this case the tendency under fixed exchange rates for the prices of traded goods in different countries to converge.

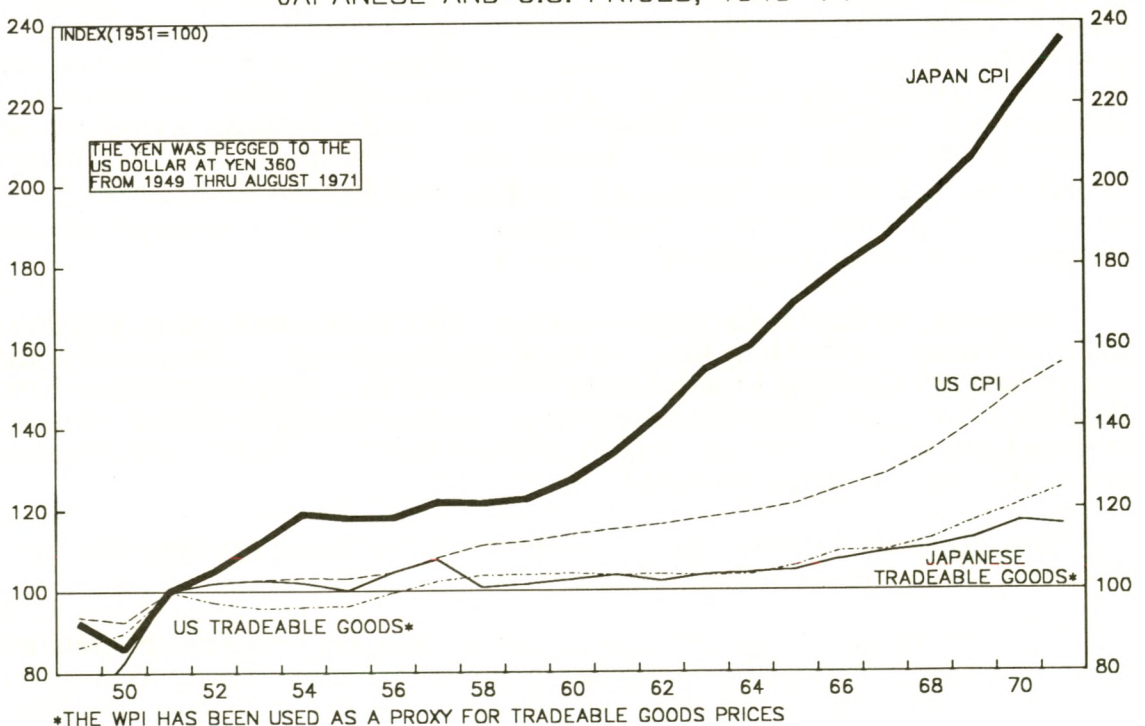
The Problem of CPI Inflation

By contrast, since 1983 Hong Kong consumer prices have behaved rather differently from export prices. This has given rise to concerns in some quarters that the Linked Rate System may somehow be undermined by CPI inflation in Hong Kong. It has also caused concern among some who feel that it is eroding the living standards of people in Hong Kong and that therefore concrete measures should be taken to limit the growth of consumer prices. Both these anxieties are misplaced. First, it is traded goods which matter so far as the competitiveness of the Hong Kong dollar is concerned. Therefore as long as the particular mix of goods and services which Hong Kong is selling abroad remains competitive, Hong Kong can continue to compete internationally at the fixed 7.80 rate. At times (such as the present), manufacturers may receive signals from the comparative level of prices that there are certain kinds of activities which are no longer competitive in Hong Kong, and this will cause the "basket" of goods produced in Hong Kong to change. Second, as far as living standards

HONG KONG: CHART 3
THE LAW OF ONE PRICE
HONG KONG AND U.S. PRICES, 1982-90



HONG KONG: CHART 4
THE LAW OF ONE PRICE
JAPANESE AND U.S. PRICES, 1949-71



are concerned, wages regularly increase faster than consumer prices in Hong Kong during an upswing of the business cycle. In other words, for the vast majority of the population real wages are rising, giving them a progressively higher standard of living.

To understand the behaviour of Hong Kong's consumer price inflation relative to the price of traded goods it is useful to examine the experience of Japan and the U.S. under the Bretton Woods system of fixed exchange rates. Between April 1949 and August 1971 the Japanese Yen was pegged to the US dollar at Yen 360 = US\$ 1.00. As shown in Chart 4, throughout this period the price of Japanese exports remained very much in line with the price of US exports; over the period Japanese export prices rose at 1.6% per annum while US export prices rose at 1.7% per annum. However, Japanese consumer prices rose at roughly double the rate of US consumer prices, i.e. 4.4% per year as compared with 2.3% per year for US consumer prices. The explanation for this is that productivity in Japan was rising much more rapidly than in the US and therefore incomes in Japan's service sector were able to rise without Japan as a whole losing competitiveness. Japan's CPI reflected the rise in service costs or - equivalently -- the rise in wages in the service sector.

In the same way that Japan was shifting from agriculture to manufacturing and from manufacturing to services in the post World War II years, so Hong Kong today is experiencing a major change in the composition of its labour force and output or GDP. With the termination of relatively free immigration as a result of the abandonment of the "Touch Base" policy in October 1980, Hong Kong's labour force is no longer able to expand "horizontally" by importing low skilled workers for the construction and manufacturing industries, so that Hong Kong today is being compelled to improve the productivity of its labour force through training and education. Lower value added tasks such as assembly for simple manufactured goods are being shifted over the border into Guangdong Province. As a result, despite lower growth of the population and labour force in Hong Kong and relatively low rates of growth of GDP, per capita incomes in Hong Kong are rising quite strongly -- more rapidly than in the USA. Today, with the Hong Kong dollar pegged to the US dollar and real incomes or productivity in Hong Kong rising more rapidly than real incomes or productivity in the USA as Hong Kong shifts from manufacturing to services, we can observe a very similar phenomenon to that observed in Japan under the Bretton Woods system. Traded goods prices in Hong Kong and the USA have remained very much in line while consumer prices in Hong Kong have been rising at roughly double the rate of increase of consumer prices in the USA.

Assuming (a) that the fixed rate link to the US\$ is maintained and (b) that these structural changes in the Hong Kong economy are going to continue to occur over the next decade or so, as Hong Kong becomes more and more closely integrated with the Pearl River Delta and Guangdong, we have to face the probability that CPI inflation in Hong Kong will continue to exceed CPI inflation in the USA. Are there any feasible or realistic solutions to this problem?

Broadly speaking, three types of solution to the inflation problem have been discussed, which take the following lines:

- (1) Viewing inflation as fundamentally a monetary problem, the inflation must be tackled by reforming the monetary system. Therefore one proposed solution is to move to a monetary system which keeps the Hong

Kong dollar strong enough to eliminate or at least reduce CPI inflation. One such solution would be to link the Hong Kong dollar to a basket of currencies instead of directly or solely to the US dollar.

- (2) Viewing CPI inflation in Hong Kong as essentially a structural problem resulting from the upgrading of the economy to high value added service activities in what is already a tight labour market, one proposed solution is to import labour so as (a) to slow down the structural shift to services and (b) to ease the tightness in the labour market.
- (3) Viewing inflation as a result of the pressure of demand on limited resources, those pressures should be reduced, as much as possible, by cutting back on total expenditures, specifically by the government. Variants of this "fiscal" approach include scaling back the wage increases of government employees, reducing indirect taxes, and reducing government expenditure as a percentage of GDP.

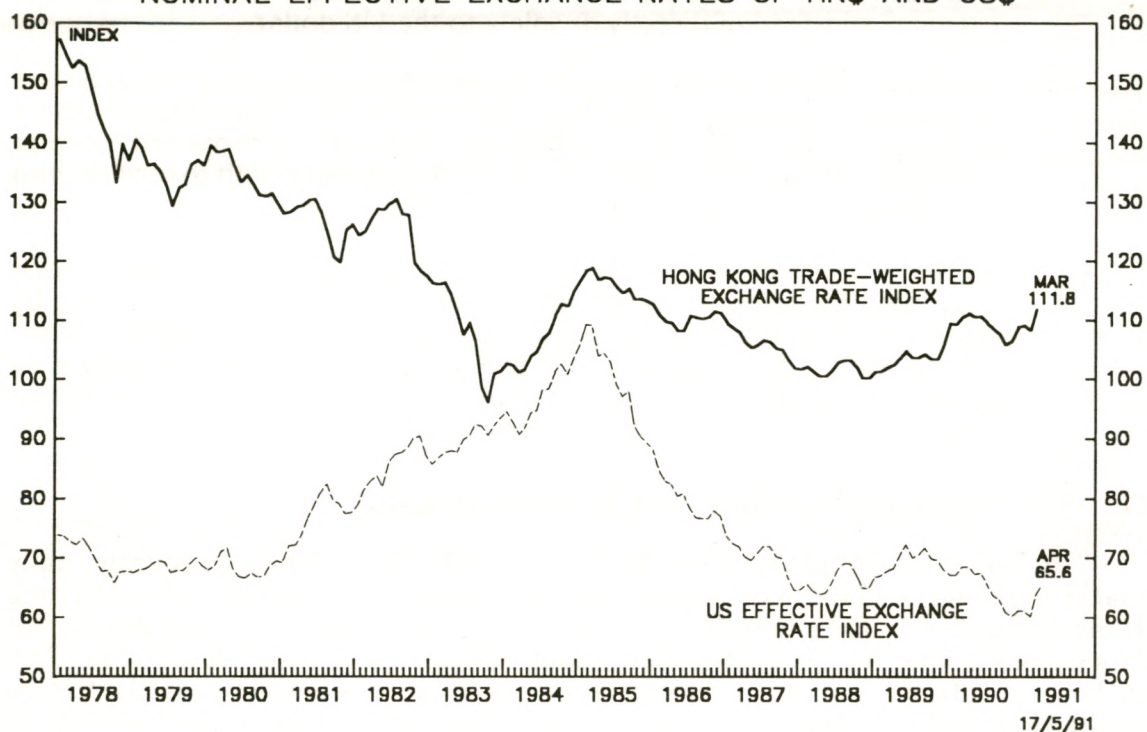
(1) The Proposal to Shift from the US\$ Link to a Basket

Proponents of alternative monetary systems for Hong Kong frequently imply that Hong Kong's CPI inflation would be solved by a basket arrangement for the Hong Kong dollar. It should be noted by those who argue for a basket arrangement for the Hong Kong dollar that even if the Hong Kong dollar were stronger than 7.8, i.e. 7.50 or 7.00, Hong Kong's consumer price inflation would (a) considerably exceed inflation in the traded goods sector and (b) would still substantially exceed the average of consumer price inflation in the countries whose currencies were included in the basket. In short, a basket arrangement would not solve Hong Kong's inflation problem, particularly when -- as at present -- the US dollar is strong. Those who argue for a basket link should also note that over time a stronger Hong Kong dollar would also accelerate the structural changes occurring in the Hong Kong economy. In other words the already rapid decline in the number of people employed in manufacturing in Hong Kong would accelerate, thereby exacerbating the difference between export prices and the CPI, and intensifying the "structural" component of inflation in Hong Kong.

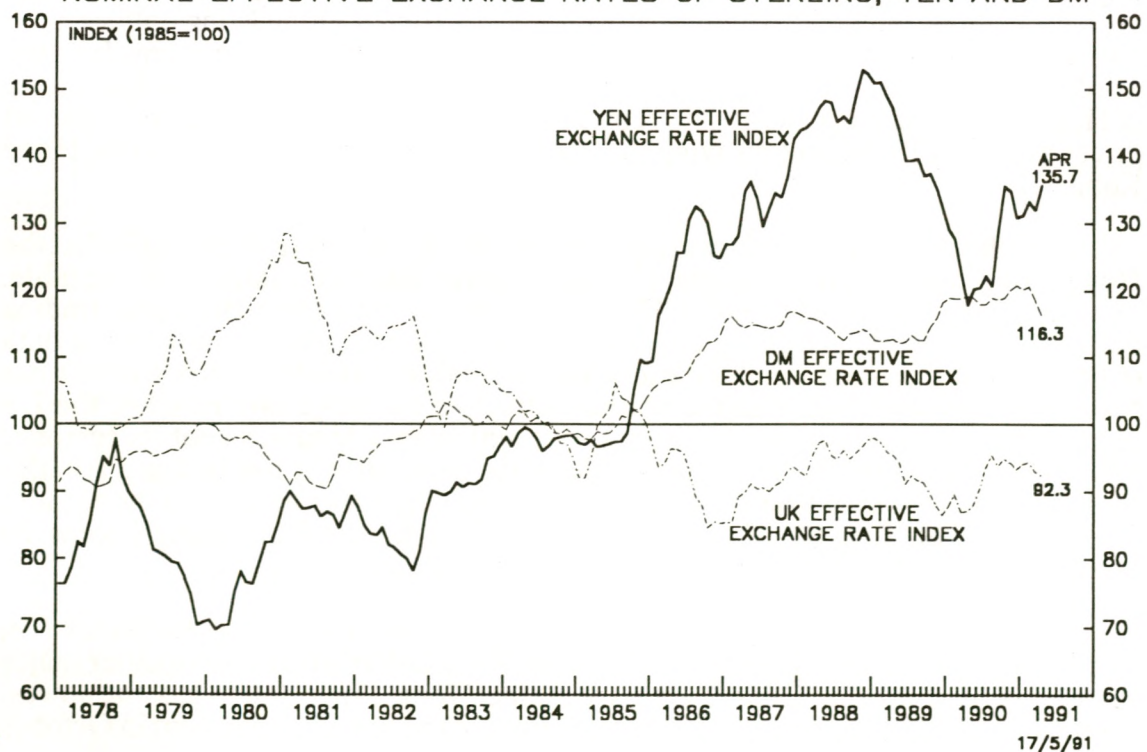
Another argument put forward by advocates of a basket arrangement is that the Hong Kong dollar is fixed to the US dollar which has been inherently unstable. However, the trading partners of Hong Kong are by no means the same trading partners of the USA, and it is quite clear from even a brief examination of the data (Chart 5) that the trade weighted exchange rate index of the Hong Kong dollar has been much less unstable than the nominal effective exchange rate index of the US dollar. The main reason for this is that in recent years China has kept its currency effectively pegged to the US dollar, while at the same time it has become a major trading partner of Hong Kong. Taking the USA and China together, they now account for some 47% of Hong Kong's total external trade or 45% of Hong Kong's domestic exports and retained imports.

Furthermore, if we compare the movement of the trade-weighted index (i.e. nominal effective exchange rate) for the Hong Kong dollar with those of other major currencies as shown in Table 1 on page 9, the Hong Kong dollar has the lowest coefficient of variation since the implementation of the linked rate system in October

HONG KONG: CHART 5
NOMINAL EFFECTIVE EXCHANGE RATES OF HK\$ AND US\$



HONG KONG: CHART 6
NOMINAL EFFECTIVE EXCHANGE RATES OF STERLING, YEN AND DM



1983, i.e. it has actually been more stable than any of the major currencies, including even the DM. (See also Chart 6.) This is because over the period since October 1983 the trade-weighted index for the HK\$ has fluctuated in the range 96-120, whereas the DM has fluctuated in the range 90-120, and the US\$ has fluctuated in the range 60-110. The reason why the DM has been more stable than the US dollar or the Yen in terms of its nominal effective exchange rate index is that the DM is at the centre of the European Exchange Rate Mechanism, and much of Germany's trade is with countries which are members of the ERM. In other words, Germany is in a similar position to Hong Kong, having most of its trade with countries to whose currency the DM is pegged. Moreover, if we consider that the vast majority of capital movements into and out of Hong Kong are in US dollars, then taking the balance of payments as a whole it is abundantly clear that the US dollar is the right currency for the Hong Kong dollar to be pegged to. In sum, the case for maintaining the Hong Kong dollar's single currency link with the US dollar is at least as powerful as the argument for keeping the DM in the ERM.

Table 1.
Coefficient of Variation for Nominal Effective Exchange Rate Indices.

	Jan. 1978 - April 1991.	Oct. 1983 - April 1991.
HKD	0.123	0.047
USD	0.157	0.182
JPY	0.232	0.151
DMK	0.089	0.068
GBP	0.101	0.057

Note on the coefficient of variation: the standard deviation for each series of monthly observations has been scaled or standardised by dividing by the mean of each series.

There is one other aspect of the proposal to link the Hong Kong dollar to a basket of currencies which is seldom alluded to by its proponents -- namely, the problem of how to operate the note-issuing system in Hong Kong under such an arrangement. At present under the single currency linked rate system all banks must pay US\$ in the ratio of 1 : 7.80 to the Exchange Fund for every Hong Kong dollar bank note they issue (if they are a note issuing bank) or receive from a note issuing bank (if they are a non-note issuing bank). Conversely, they will receive US dollars in the same ratio for every Hong Kong dollar bank note redeemed or taken out of circulation. It is this convertibility of the Hong Kong dollar at a fixed price which is the cornerstone of Hong Kong's monetary system today.

Now suppose that a basket arrangement is introduced to replace the fixed, single currency link to the US dollar. How will the note issue mechanism operate?

Let us consider the case where the Hong Kong dollar is defined in terms of a fixed but limited basket of foreign currencies e.g. US\$, Japanese Yen and DM. For concreteness we shall take the case where HK\$ 1000 is defined as US\$ 100 plus Yen 2000 plus DM 25. The banks will immediately wish to avoid the inconvenience of paying to and receiving from the Exchange Fund mixed baskets of currency in these ratios, so an arrangement would no doubt very quickly be devised to pay US\$ in amounts corresponding to these ratios at exchange rates prevailing at a specified time

of day. The rate for the Hong Kong dollar against the US\$ would still be the crucial centrepiece, except that instead of remaining fixed at 7.80, it would be changing from day to day.

Problems with the Basket Proposal

This type of system has three main problems associated with it. First, for the man-in-the-street or, perhaps more important, for the Hong Kong based manufacturer of exported goods, the certainty that was previously associated with the 7.80 rate would disappear. Businessmen -- exporters and importers -- frequently say how relieved they were when the HK dollar was fixed in October 1983, and how awkward it would be for them if it were now to be shifted to a variable exchange rate system. The conclusion must be that there would have to be other substantive advantages which would outweigh the loss of the certainty of the 7.80 rate before it would be worthwhile changing the system.

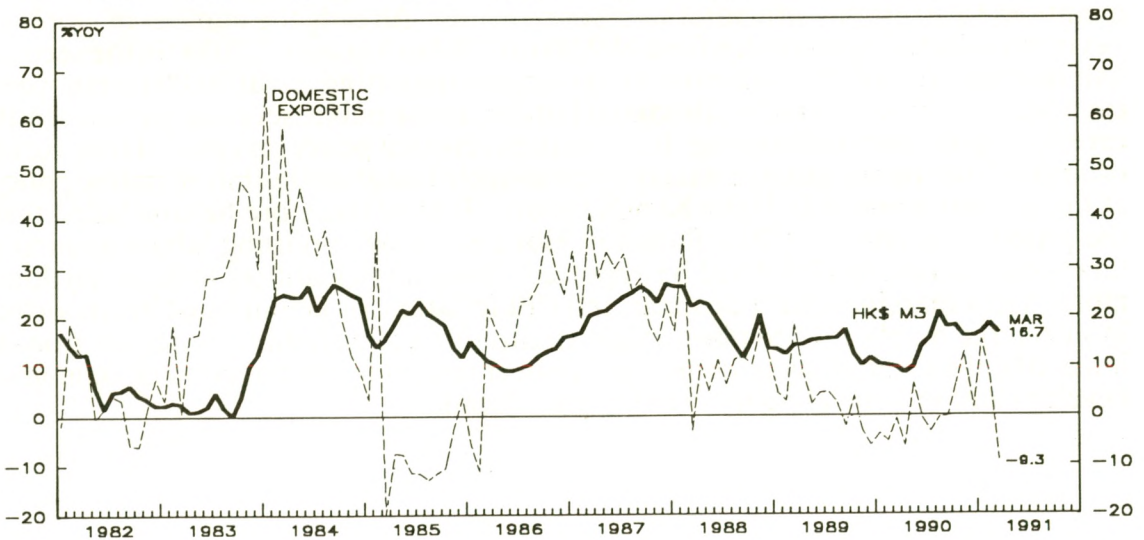
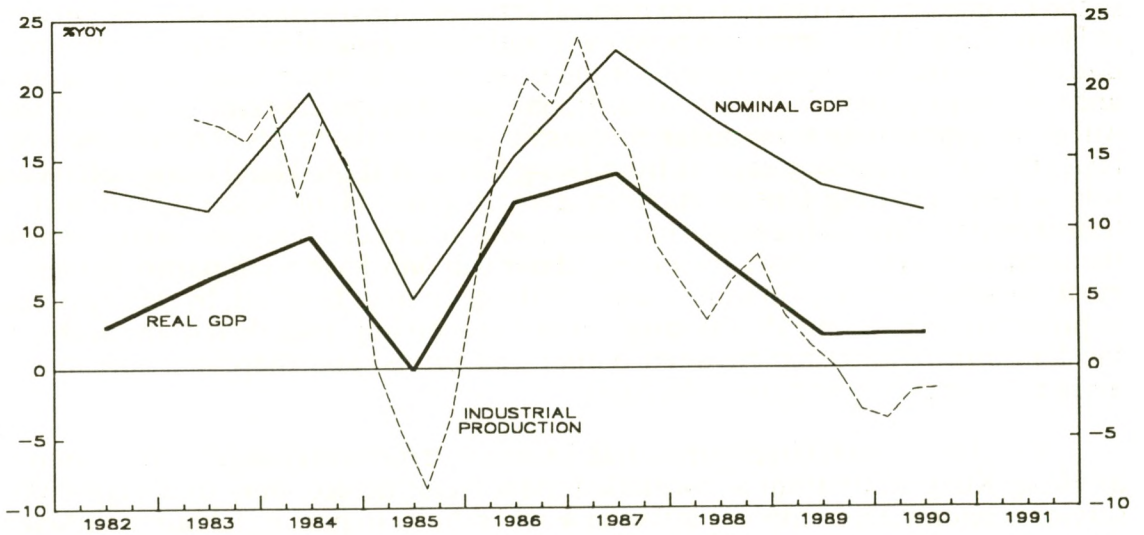
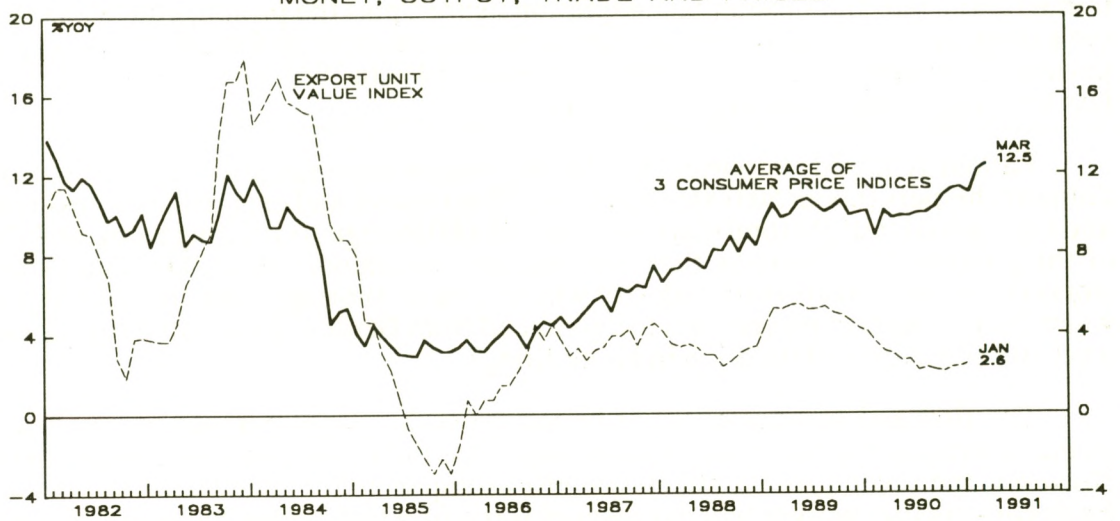
A second type of difficulty inherent in moving to this kind of basket system relates to the question of interest rates. Even with the Hong Kong dollar rigidly fixed to the US dollar there is considerable variation between Hong Kong dollar interest rates and US dollar interest rates. If a basket system were adopted, it would be much more difficult to know what Hong Kong interest rates should be at any point in time, and this would further undermine the certainty and stability associated with the single currency, fixed rate link to the US dollar.

Finally, the third drawback to the basket system, and one which is much more serious in the longer term, concerns the question of the composition of the basket. Whatever the initial ratios or weights for the component currencies of the basket, Hong Kong's trade and payments structure will change over time leading to calls for a shift in the composition of the basket. Exporters would argue for the inclusion of weaker currencies; importers would argue for the inclusion of stronger currencies. Within a short space of time it can be confidently predicted that Hong Kong would shift from a fixed basket to a variable or discretionary basket -- in other words the level for the Hong Kong dollar currency against other currencies would be decided on a day-to-day basis by bureaucrats. These individuals would inevitably become the focus of great political pressure from a variety of interest groups -- exporters, importers, mortgage borrowers and others. In short, moving to a basket arrangement for the Hong Kong dollar would make the Hong Kong system much more subject to political pressures than it currently is. The Hong Kong dollar is currently subject to a monetary rule : convertibility of the banknotes at a fixed rate of HK\$ 7.80 = US\$ 1.00, which minimises the possibility of political manipulation. Moving to a basket system would soon make the Hong Kong currency system subject to bureaucratic discretion, which in turn would greatly enhance the likelihood of political interference in the monetary system.

(2) The Proposal to Import Labour into Hong Kong.

Another proposal that is frequently advocated is to import more manual and semi-skilled labour into Hong Kong. To see this in perspective it should be noted that in recent years there have been some fundamental changes affecting the labour market in Hong Kong. First, there has been a virtual stoppage of the relatively free immigration from mainland China which was ended in October 1980. Second, since 1985 the annual emigration figures have climbed steadily to a point where they are

HONG KONG: CHART 7
MONEY, OUTPUT, TRADE AND PRICES



now approximately one percent of the total population. Third, with the reduction in immigration, plus the substantial emigration figures, plus the prolonged US business cycle upswing from 1983 to 1990, the labour market has tightened markedly in the past decade. Compared with an unemployment rate of 4% in 1983, unemployment fell to less than 2% of the work force in 1987-90.

Labour is already imported into Hong Kong in some specific sectors -- notably domestic helpers (about 50,000 Filipina and Thai maids), and expatriate professional and managerial staff. In total there are over 246,000 foreigners in Hong Kong, or 4.2% of the population. Currently there are proposals to import 10-15,000 semi-skilled workers for the construction industry where serious shortages are foreseen if and when the new airport project gets the go-ahead from Beijing. How can this proposal work to reduce overall inflation in Hong Kong?

The first and obvious effect of importing such a large number of employees would be to make the rise in construction wages less than it otherwise might have been. However, the second round effects are just as important if somewhat less obvious. Each construction worker will earn wages some of which he (or his employer) will spend on housing, on transport, on medical services, and on other goods and services in Hong Kong. This purchasing power will add to the general pressure on resources, ultimately requiring more imports for the economy as a whole, and raising incomes and spending by comparable amounts. If some of the wages are remitted abroad, that will either place Hong Kong dollar purchasing power in the hands of non-Hong Kong residents so they can buy exports from Hong Kong, or if the Hong Kong dollars are sold before remitting foreign currency abroad, those Hong Kong dollars will be transferred to somebody else in Hong Kong who in turn can buy goods and services in the local economy. In short, importing labour will only have a temporary impact, at most, on wages or prices in some sectors of the economy. In effect, by raising output or production (= income) by the same amount as spending it will do nothing to change the long run relationship between output and prices, and therefore have only a marginal, temporary impact on inflation.

If CPI inflation is largely structural, i.e. due to structural changes in the economy as Hong Kong shifts from a low-skilled manufacturing economy to a high-skilled service economy, then stopping inflation would require importing labour in sufficient quantities to arrest this structural shift permanently. Already the number of employees in manufacturing has fallen from 899,000 in 1984 to just over 730,000 in the second half of 1990. To arrest this decline would require importing about 30,000 employees each year, which would put a substantial burden on the public services such as health care, transportation and housing. It is most unlikely that policy makers in Hong Kong or, indeed, the public at large would agree to such a large-scale shift in public policy at the present moment in Hong Kong's history. It must therefore be concluded that the proposal to contain CPI inflation in Hong Kong by importing labour is simply unworkable. Either labour will be imported in too small numbers to have anything more than a marginal effect on measured CPI inflation, or labour must be imported in such large numbers as to place major strains on existing public services, seriously impacting the community at large, and in effect reversing the direction of economic development and social policy over the past decade.

(3) Proposals to Limit CPI Inflation Through Fiscal Measures.

In view of the limited ability of the Hong Kong authorities to do anything about inflation by monetary means as a result of the fixed link between the Hong Kong dollar and the US dollar, attention frequently focuses on curing CPI inflation by fiscal means. These schemes come in various different guises which can be classified under three distinct headings.

First, there are proposals to limit government expenditures. In general terms limiting government activity in the economy is worthwhile for reasons of efficiency, to maximise the scope of personal freedom in spending incomes, and to minimise the disincentives to work and innovation which come from ever higher tax rates. However, while these gains are important in the long run, and could amount to output gains of a percentage point or two in any one year, they are not significant enough to solve the CPI inflation problem which Hong Kong is currently facing. This is easy to see when it is understood that equal reductions of government revenue and expenditure will transfer purchasing power back into the hands of the private sector, enabling the private sector to spend the dollars that previously were spent by bureaucrats. In the case where the government spends less but still raises the same amount of revenue (i.e. reduces its deficit or increases its surplus), the result is the same even though some economists believe that this is somehow withdrawing funds from the economy. The reason is that unless there is a simultaneous change in monetary policy to withdraw funds from the banking system -- a tactic which the Hong Kong government has very little latitude to carry out under the linked rate system -- the surplus funds of the government will simply be loaned to the private sector through the banking system, with the result that the private sector spends more through borrowing while the public sector spends less.

Second, there is the proposal that public sector wages should be kept down in order not to encourage excessive wage increases in the private sector. In a macro-economic sense it is not possible for this kind of public-private-public wage spiral to occur unless monetary growth accommodates such progressive wage increases, so again, given the inability of the Hong Kong authorities significantly to manipulate monetary trends under the linked rate system, this kind of proposal has no solid basis. The main effect of higher wages in the public sector will be to raise recruitment into the public sector, and if there is any spillover into the private sector, the main effect will be to raise wages at the expense of profits or other income components of the national income.

Third, the proposal is sometimes made to avoid increasing inflation by raising direct taxes rather than indirect taxes. This proposal confuses measured prices with underlying or core inflation. Raising indirect taxes has an immediate, once-for-all impact on measured prices, but in a fundamental sense it does not raise the underlying, on-going rate of price change. Since it is total nominal expenditures relative to real output which determines inflation (i.e. expenditures by government and private sector together), the only way to prevent inflation in this sense is to control or contain total nominal spending, a capability which again, in Hong Kong, is subject to the constraints of the linked rate system.

To summarise this section, the fiscal measures which are put forward as proposed solutions for Hong Kong's CPI inflation problem are generally wide of their target and cannot succeed in arresting the inflation even if they may have other merits such as reducing government involvement in some areas of the economy.

CONCLUSION AND FORECAST: Leaving aside proposals such as price/wage controls or schemes to force down the prices of public utilities and public transportation (MTRC or KCRC fares, etc.), the three main types of proposal to control Hong Kong's inflation have been shown to be unequal to the task. Taking them in reverse order, fiscal measures cannot succeed unless they are accompanied by sustained monetary restraint (which is not feasible under the linked rate system); importing labour on a small scale will not stop the inflation, and importing low-skilled labour on a large scale would reverse much of the economic progress of the past decade; finally not only would tampering with the linked rate system for the Hong Kong currency undermine stability in a general sense, but it is highly doubtful if there would be any significant impact on reducing the differential between CPI inflation and the inflation in traded goods (the export unit price index.) Indeed, there are other merits inherent in the fixed rate link which would be undermined by a basket arrangement.

Specifically, the current linked rate system for the Hong Kong dollar provides Hong Kong with monetary stability in four fundamental ways which would not be assured under either a basket arrangement or under a floating rate system. First, the fixed link with the US dollar at HK\$ 7.80 ties interest rates in Hong Kong closely to US dollar interest rates. Second, it ensures greater stability for monetary growth than in the pre-link days. Third, it anchors the prices of "tradeable goods" in Hong Kong to the price level of internationally traded goods in the USA, by far the largest market in the world, and still the largest market for Hong Kong's domestic exports. Regrettably, however, the linked rate system does not guarantee stability of the CPI in Hong Kong, nor does it even ensure that Hong Kong's CPI remains in line with the CPI in the USA. As in the case of Japan under the Bretton Woods pegged exchange rate system, Hong Kong's CPI increases are likely to exceed increases in the US CPI for some years to come. This is mainly a result of structural changes in the economy as Hong Kong shifts to a high value-added, service-based economy serving both the Asian region and the Guangdong hinterland. Since these changes would be occurring no matter what monetary system Hong Kong adopted, even a basket arrangement would provide no guarantee of price stability in Hong Kong. Finally, the supreme advantage of the fixed link is that it is clearly fixed at 7.80 and not subject to political, bureaucratic or technical manipulation. In combination with the absence of foreign exchange controls, this gives Hong Kong citizens a far greater degree of freedom, certainty and stability than almost anything else in Hong Kong's present unwritten constitution or its post-1997 written constitution (The Basic Law) except perhaps the rule of law itself.

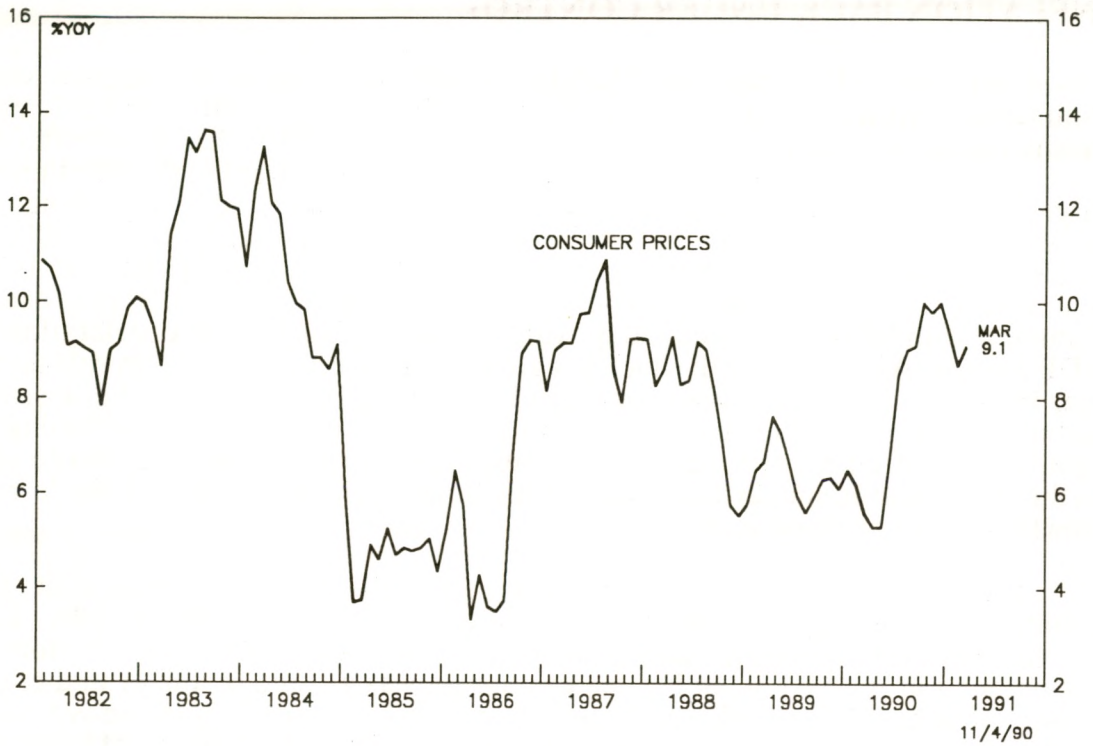
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INFLATION BACK UNDER CONTROL

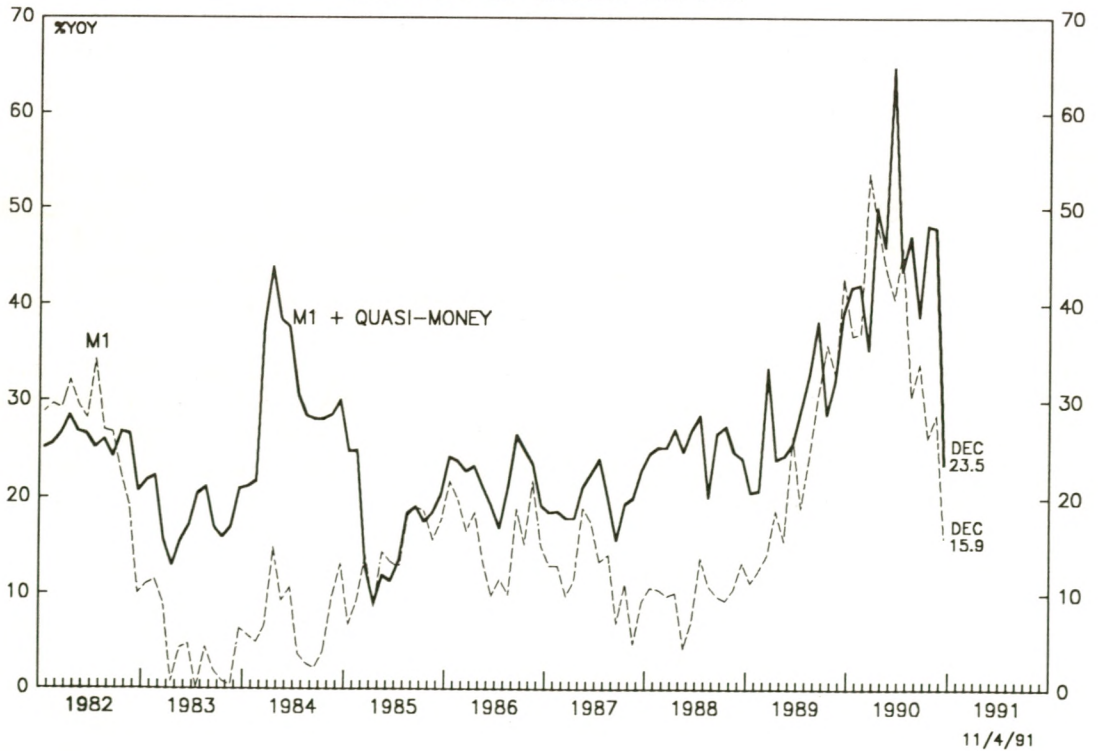
Over most of 1990, the rate of inflation in Indonesia was on the rise increasing from 5.3% in April to 10% by October (Chart 1). The CPI remained around this level for the rest of the year but over the first three months of 1991 it has decelerated to 9.1%. It is to the authorities' credit that they seem to have prevented the inflationary surge from continuing to the levels well in excess of 10% suggested by a combination of lax monetary management and explosive financial deregulation from 1988 onwards. Unlike the Thai authorities, for example, Bank Indonesia (BI) has been running an extremely tight monetary policy since the middle of 1990, preferring to take a tough anti-inflationary stance today, with the sacrifice of a slight deceleration in GDP growth. As a result GDP which has grown at an average of 6.5% in real terms over 1988-90, will probably slow to between 5-6% during 1991. However, because the authorities seem likely to retain their anti-inflationary zeal and are continuing to tighten supervision over financial institutions, there appears to be little chance of a further explosion in money and credit. This bodes well for strong and stable real growth over the next few years.

The inflationary surge over 1990 has its roots in the low interest rate policy (by Indonesian standards) in place from the end of 1988 to the middle of 1990. This coincided with the wholesale deregulation of the banking and financial sectors as documented in AMM Vol. 14 No. 5. The upshot was a surge in money and credit growth (Chart 2). M1 growth accelerated from an average of 10% year-on-year over 1988 to 53.8% in March 1990. Meanwhile, the growth of the broader M1+Quasi-Money peaked at 64.9% in June 1990 compared to an average growth rate of 25.3% during 1988. Clearly the Indonesian authorities underestimated the monetary consequences of financial deregulation although in their defence they are hardly unique in this respect. However, when money growth started to really take off -- M1+Quasi-Money accelerated from under 40% to over 60% in the first half of 1990 -- they moved swiftly to tighten sharply in an attempt to maintain the rate of inflation below 10%. The weighted interbank call rate rose from 11.5% in May 1990 to 15.25% in June and 21.5% in December (Chart 3). However, concerns over excess liquidity remained and at the end of February Finance Minister Sumarlin unveiled his "Sumarlin Shock II". The details of this policy are outlined in AMM Vol. 15 No. 2. It is unclear just how much of the Rupiah 7-8 trillion of state company deposits withdrawn from the system has been and is to be replaced. The companies were forced to buy central bank paper or SBIs, and in return could sell repurchase certificates or SBPUs to BI up to a limit of 75% of the withdrawn deposits. Additional SBPUs worth 15-20% of the deposits could then be auctioned as necessary. However BI has left itself the option of tightening further. By borrowing at a 1-year maturity and lending at maturities less than or equal to 1 year, the central bank can drain additional liquidity by not rolling over the SBPUs.

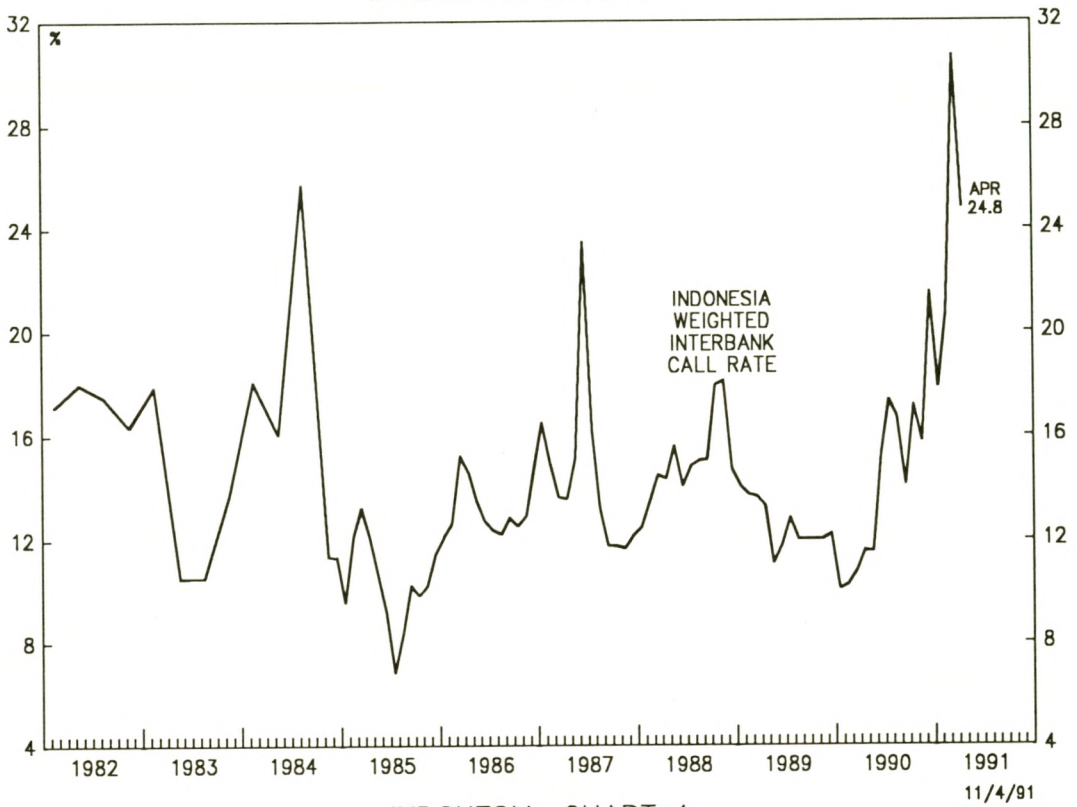
INDONESIA: CHART 1
INFLATION



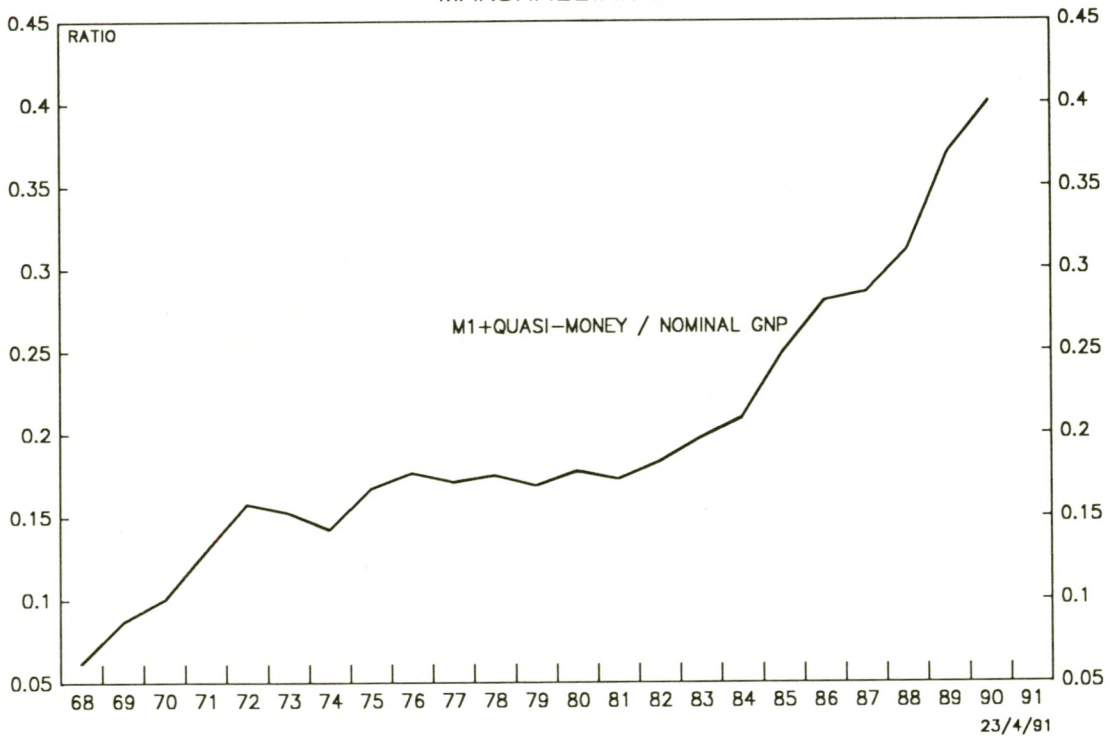
INDONESIA: CHART 2
GROWTH OF MONEY SUPPLY



INDONESIA: CHART 3
INTERBANK CALL RATE



INDONESIA: CHART 4
MARSHALLIAN k



As liquidity has trickled back into the system, interest rates have started to ease again. The interbank call rate which jumped to 35% immediately after the measure was introduced and averaged 31% over March as a whole, now stands at under 25%. Deposit rates have been slower to respond as banks, the major victims of the squeeze, are attempting to widen their margins, at least temporarily. State and private bank deposit rates have only declined on average by 100 basis points.

However, the trend in interest rates is now clearly down and by mid year they may be approaching 20%. Traditionally when rates are in the 15-20% range Indonesians consider that monetary policy is relatively easy. Whether they can fall further will depend on BI's response to the money supply and inflation figures. Their stated target for inflation is three consecutive month's growth of less than 0.5%, and given that the April CPI will comfortably exceed 0.5% due to the normal surge in consumption at the end of Ramadan, this goal will only be met when the July CPI data becomes available at the earliest. Money supply growth meanwhile suggests that inflation will be able to continue to slow. December 1990's figures for M1 and M1+Quasi-Money showed a marked deceleration that can be expected to have continued over the first quarter of 1991. Nevertheless, BI is taking no chances as a considerable liquidity overhang probably remains, notwithstanding the sharp fall in velocity or equivalently the steep rise in Marshallian K, since 1988 (Chart 4). As mentioned above, it has given itself the option of a further abrupt tightening, and in an attempt to prevent the kind of credit explosion seen during 1988-90, a package increasing financial supervision has been introduced. This package is summarised in Table 1 below.

Table 1

PACKAGE OF FINANCIAL REGULATORY REFORMS - 14TH MARCH 1991

- (1) A timetable has been introduced for banks to comply with capital-adequacy standards similar to those of the BIS. Capital levels must be equivalent to 5% of risk-weighted assets by March 1992, rising to 7% by March 1993 and 8% by December 1993.
- (2) Offshore borrowing is to be restricted. Maximum net open foreign currency position are to be restricted to 20% of capital, against 25% previously.
- (3) Banks who trade currencies on behalf of customers will be subject to a minimum margin level of 10%. Margin deposits are to be reported to BI on a weekly basis.
- (4) Bank lending to stock trading companies is to be prohibited.
- (5) Banks are to be allowed to take equity stakes in foreign financial institutions.
- (6) Banks will be required to increase expenditure on personnel training and bank owners will be discouraged from appointing family members to supervisory positions.

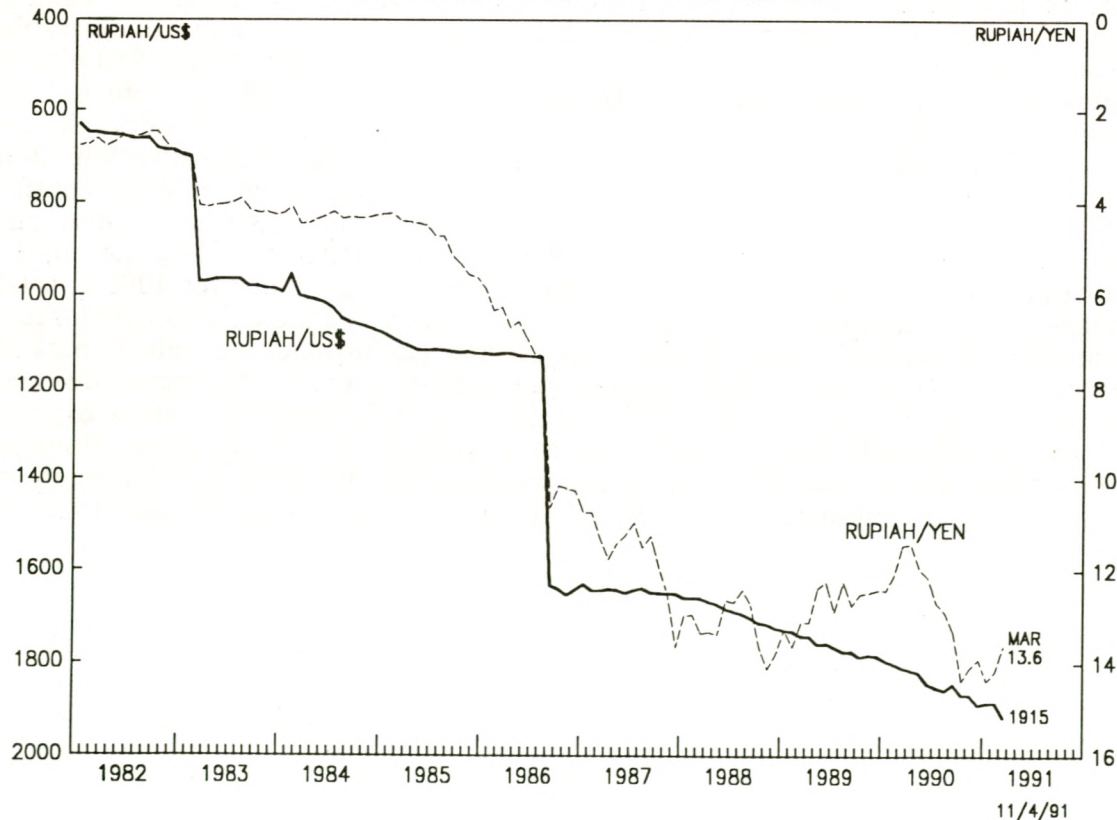
One of the implications of this package is that many Indonesian banks will need to raise capital, but their allowed exposure to overseas borrowing will be limited. This should facilitate the development of the domestic money and bond markets and give a boost to equity market issuance. On the downside for the stockmarket, the rules on bank lending will restrict the amount of new money entering the market and may force brokers to liquidate portfolios purchased with borrowed funds. The measures improving bank supervision and management skills are timely and to be applauded.

Although preventing another inflationary spurt appears to be the authorities' major concern, the avoidance of a sharp Rupiah devaluation remains high on the agenda. In addition to draining excess liquidity, the Sumarlin Shock II was aimed at quashing devaluation rumours. Following the end of the Gulf war, fears abounded that the price of oil would collapse leading to a sharp deterioration in the current account. As a result, individuals and institutions were selling Rupiah for US\$ anticipating a steep fall in the currency. The rapid rise in interest rates and the decision of OPEC to target a \$21 per barrel oil price succeeded in preventing a run on the currency, and this was reinforced by the publication of better than expected balance of payments figures.

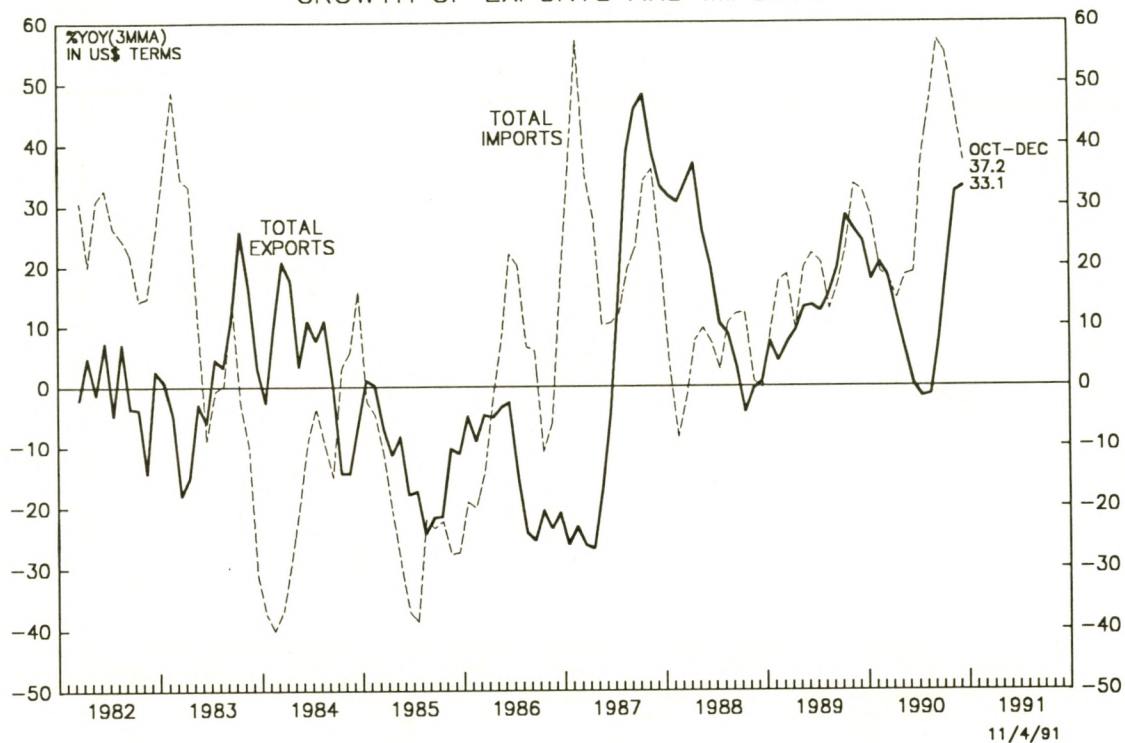
The Indonesian authorities seem determined to continue with their policy of gradual Rupiah devaluation against the US\$ (Chart 5), which should help to keep the current account deficit -- currently around 2.4% of GDP -- under control. A sharp depreciation in the currency -- against the US\$ or the Yen -- remains undesirable because of its disruptive nature and due to a huge external debt of over \$50 billion which requires an annual service of \$8 billion. Around 20% of this debt is US\$ denominated while 40% is denominated in Yen. However, gradual depreciation helps to maintain Indonesia's export competitiveness. Total export growth rebounded strongly during the second half of 1990 (Chart 6) but these figures need careful interpretation as approximately 40% of exports are oil and gas related products. Stripping out these two components, export growth remains negligible while import growth continues to boom. This may seem surprising given that over 40% of total exports are to Japan, and a further 20% are within Asia, while the US accounts for less than 20%. However, again stripping out oil and gas products reveals a marked difference. The remainder of Indonesia's major exports consist of commodities and textiles and Japan accounts for only 22% of the total. A further 37% of these exports are within Asia, with Europe and America accounting for similar proportions as Japan. With Japan and Asia slowing and much of the rest of the world already in recession, significant increases in these non-oil and gas exports may be hard to come by.

Nevertheless, the overall balance of payments position appears reasonably healthy. The trade surplus and the current account deficit will probably deteriorate slightly this year (Chart 7) as import growth continues to outpace export growth. However, the acceleration in imports owes much to increased purchases of capital goods which now represent 46% of imports as opposed to 20% in 1988. Consumer good imports remain at only 5% of total imports with raw materials and intermediate goods accounting for the rest. These capital goods are sorely needed to upgrade Indonesia's manufacturing base and infrastructure, and in the long run should lead to increased export growth. Furthermore, the oil price now seems unlikely to collapse and the country has a comfortable cushion of reserves. Reserves surged 32% to \$8.7 billion or 6 months' import cover during 1990, due to a large net capital inflow of \$3.77 billion which led to a healthy overall balance of payments surplus (Chart 8). Much of the increase on the capital account can be attributed to the acceleration of foreign direct investment (FDI) which in the first 9 months of 1990 alone jumped to \$7.1 billion compared to \$4.7 billion for the whole of 1989 (Chart 9). The bulk of this increase is a result of increased FDI from Japan and the NICs which now represents 52% of total FDI as opposed to 42% in 1989.

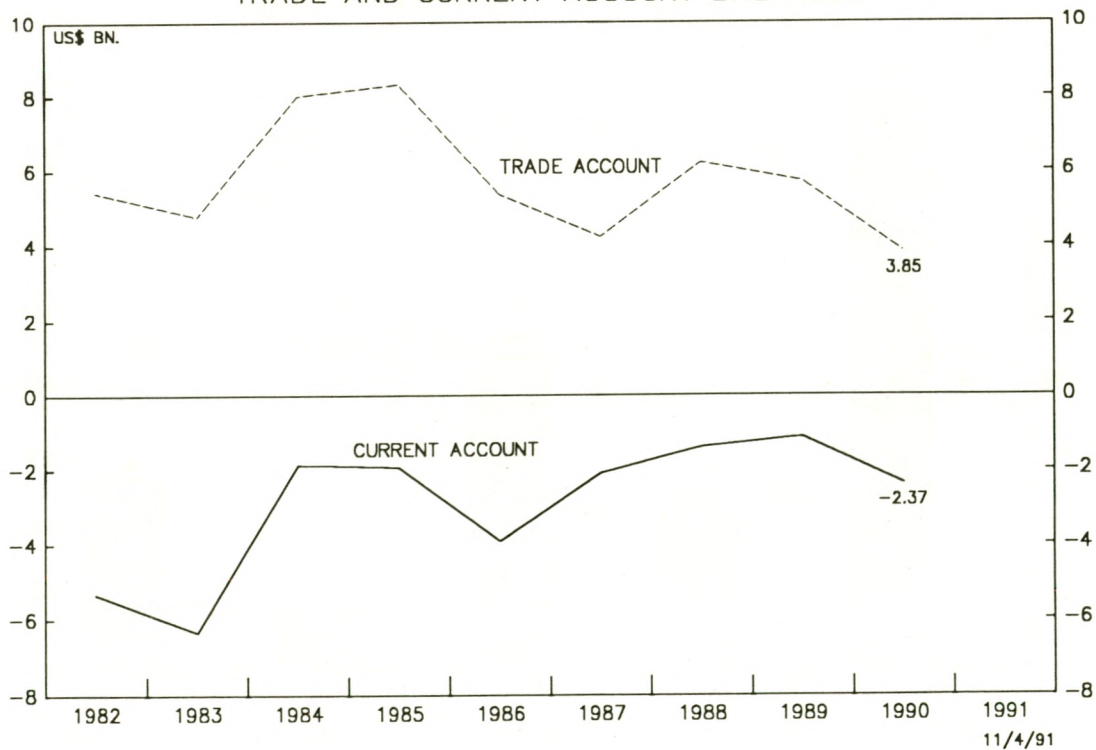
INDONESIA: CHART 4
EXCHANGE RATE FOR THE RUPIAH



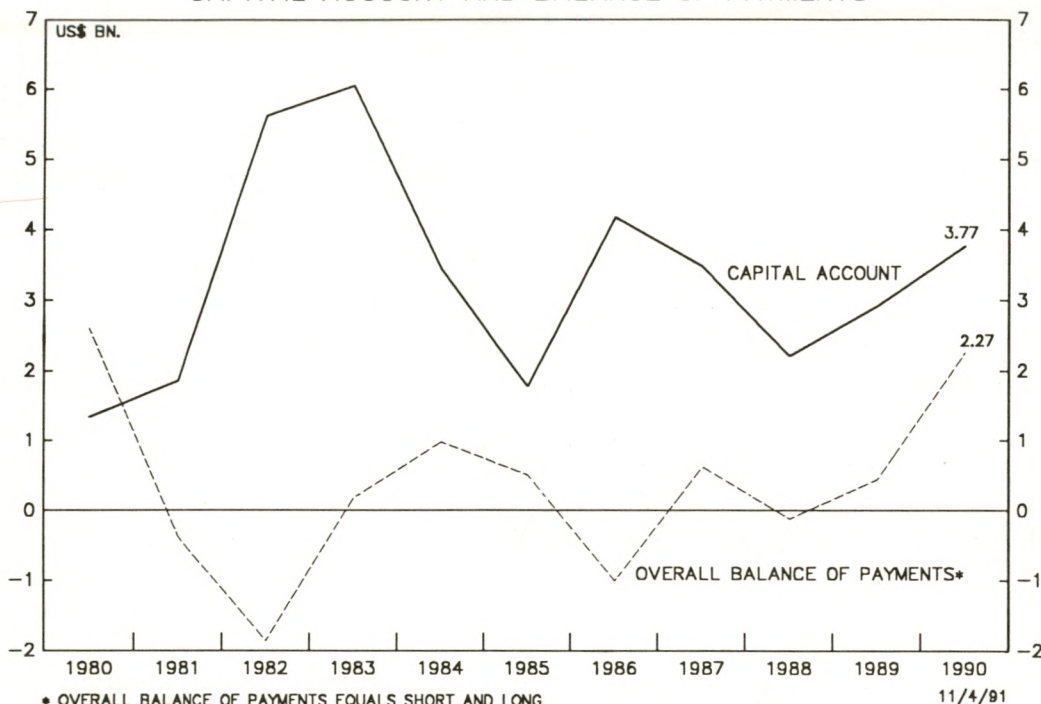
INDONESIA: CHART 6
GROWTH OF EXPORTS AND IMPORTS



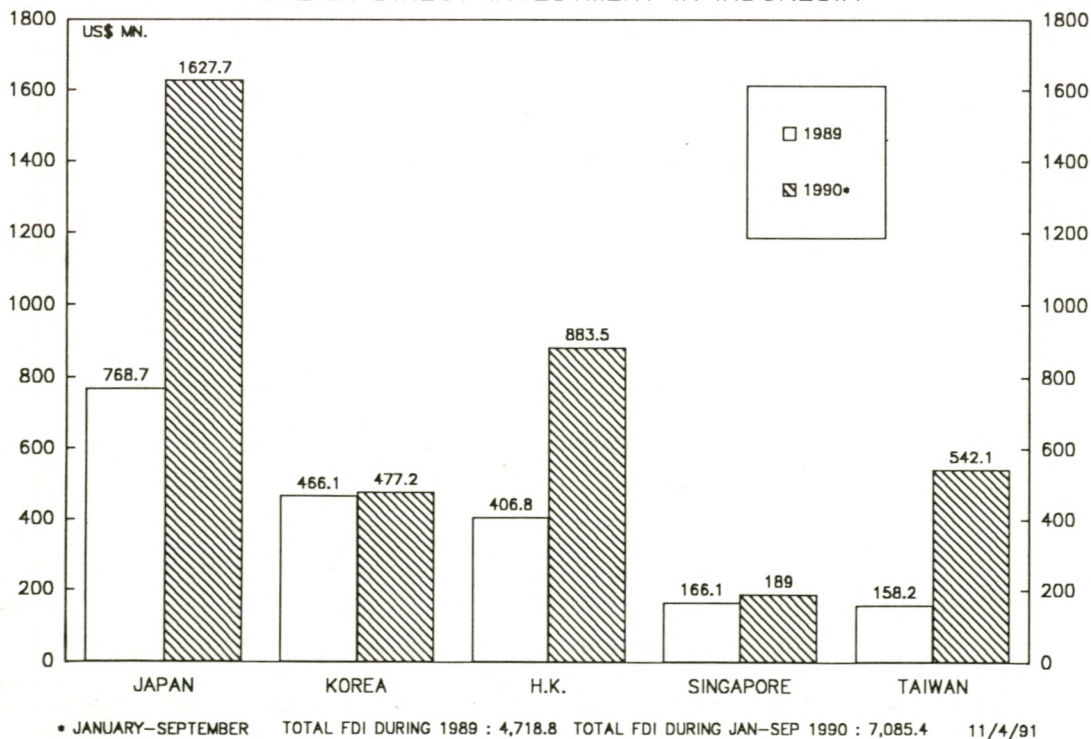
INDONESIA: CHART 7
TRADE AND CURRENT ACCOUNT BALANCES



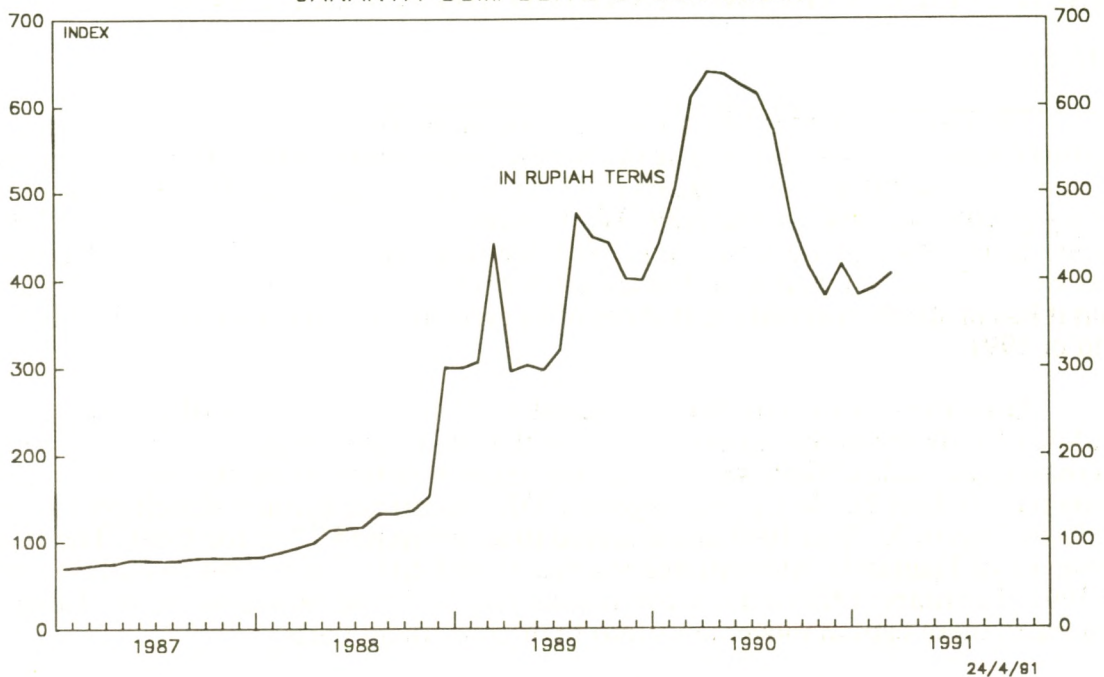
INDONESIA: CHART 8
CAPITAL ACCOUNT AND BALANCE OF PAYMENTS



INDONESIA: CHART 9
FOREIGN DIRECT INVESTMENT IN INDONESIA



INDONESIA: CHART 10
JAKARTA COMPOSITE STOCK INDEX



SUMMARY AND FORECAST: By taking the decision to clamp down on money and credit growth sooner rather than later, the Indonesian authorities should be able to achieve their target of 7% inflation over 1991. Perhaps more importantly though, they seem determined to implement policies to prevent another explosion in liquidity. This is reflected in the new package of financial reforms and continued fiscal rectitude. Although the budget for fiscal 1991-92 allows for an 18% rise in nominal spending, almost all of this increase is on the capital account while current expenditure has remained flat. This increased capital expenditure is to be welcomed as the acceleration of economic activity over the last couple of years has placed great strains on an inadequate infrastructure. The result has been bottlenecks and shortages that have contributed to inflationary pressures.

The avoidance of an explicit Rupiah devaluation remains the authorities' other major goal, but gradual Rupiah depreciation against the US\$ will continue. The current account will probably deteriorate slightly this year as import growth continues to outstrip export growth but capital inflows should more than offset any deficit. Furthermore, almost half of imports are of much needed capital goods which are required to stimulate an upturn in non-oil and gas exports.

Interest rates are certainly trending downwards, and should be nearing 20% or less by mid year. However, BI retains the tools to tighten monetary policy sharply once again should inflationary pressures show signs of rising once more. The Jakarta stock exchange index which has moved little since August 1990 (Chart 10), will likely continue to track sideways over the next few months as liquidity in the market remains tight. However, although tight monetary policy has certainly hurt the profitability of many firms over recent months, underlying margins remain strong. Therefore, easier monetary conditions towards the middle of the year could herald a new move upwards in the Indonesian market.

THAILAND FISCAL POLICY HAS RESTRAINED MONETARY EXPANSION

Introduction

Thailand in the mid 1980s achieved exceptional GDP and export growth rates putting it firmly amongst the league of the new "emerging dragons". As Chart 1 shows during 1988 real GDP grew in excess of 13% p.a. with exports growing at no less than 30% yoy from mid 1987 to mid 1989. With exports to the US accounting for over 20% of the total for most of the period since 1988, the slowdown of the US economy has now taken its toll. The current short to medium term prospects for the Thai economy are that it has probably reached the bottom of its cycle and could trough out towards the end of 1991.

Growth rates such as those achieved by Thailand are not costless. Since the middle of 1989 the acceleration of the growth rates of imports in relation to exports increased the trade deficit, with the current account deficit rising at more or less the same pace (Chart 2). As a percentage of GDP the current account deficit grew from 2.8% in 1988 to 3.7% in 1989 and doubled to an estimated 7.5% for 1990. The rise, however, of Thailand's international reserves from USD7.1 bn in 1988 to USD15.6 bn in 1991 (February) reflected the continuous surplus in the capital account. Table 1 separates these capital movements into their constituent parts.

Table 1

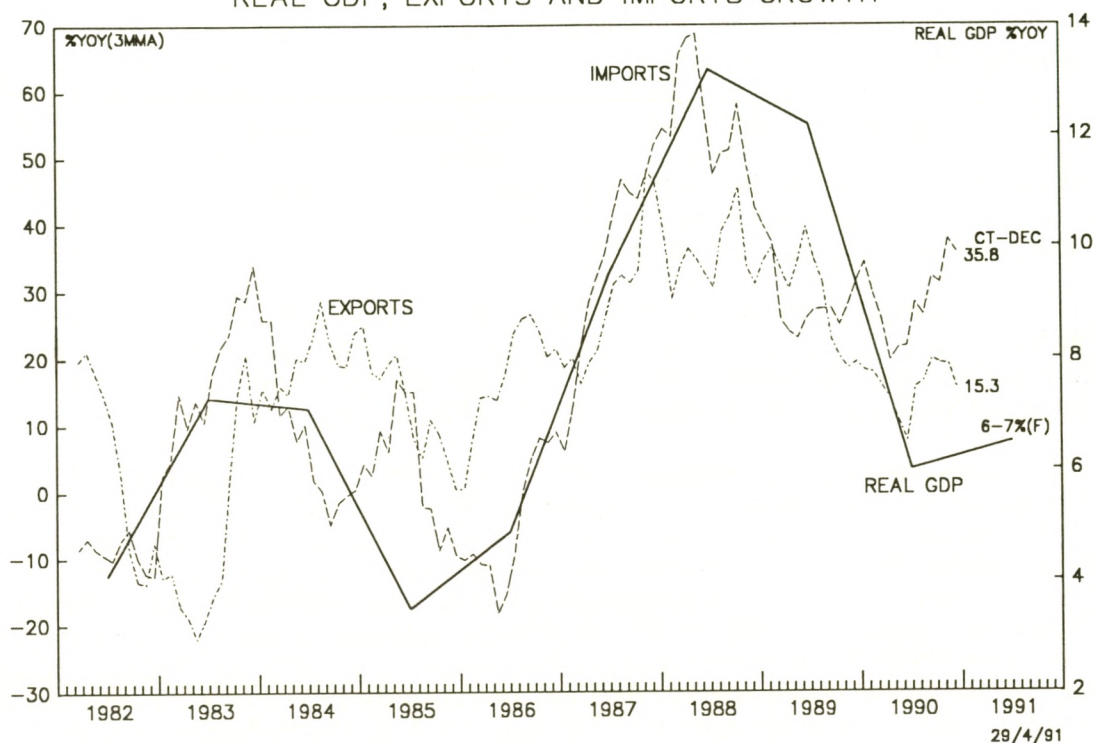
Components of the Net Capital Account as percentage of total 1988-1990 (Q3) (mn Baht)

	1988	1989	1990		
			Q1	Q2	Q3
1. Direct investment	38.1	28.4	26.9	30.1	32.3
2. Portfolio investment	15.2	23.7	48.9	23.3	-0.2
3. Private long term capital	2.9	22.9	6.0	16.0	23.4
4. Private short term capital	45.5	29.8	14.7	56.9	86.3
5. Central government & state enterprises	-1.9	-5.0	3.2	-26.4	-41.9

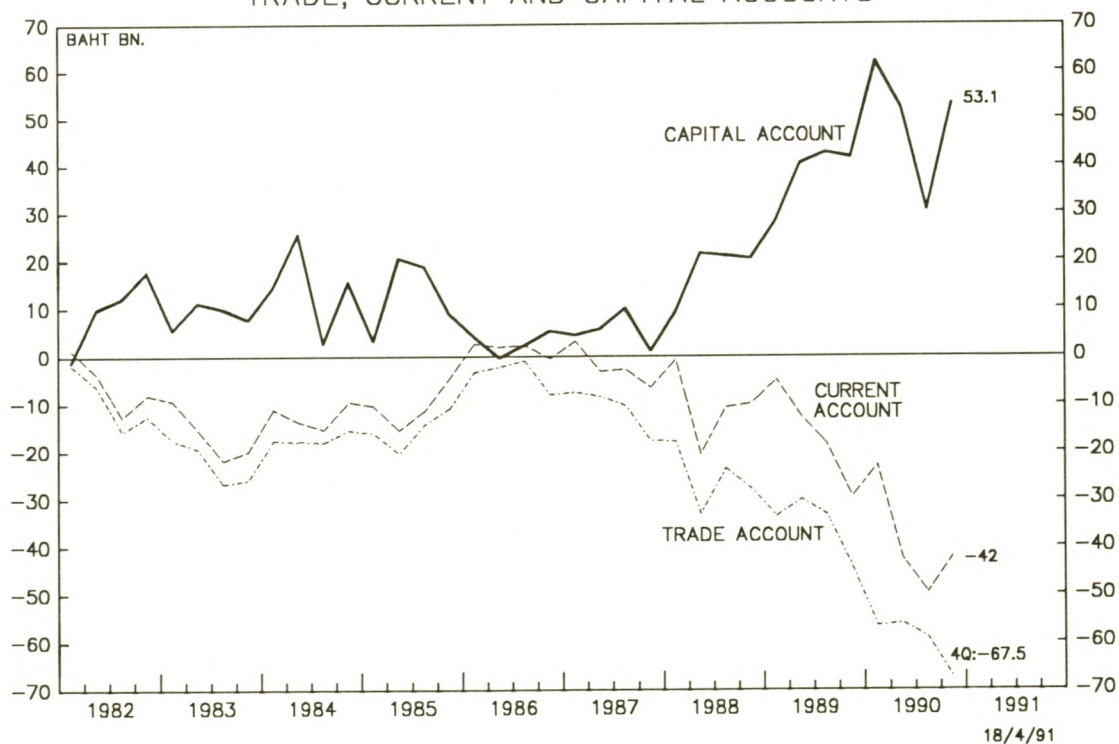
(Figures do not add up to 100 because of rounding)

A preliminary estimate for 1990 as a whole shows that the state continued repaying its external debt at the rate of baht 31.6 bn, whereas the private sector generated a net inflow of baht 231.4 bn yielding a net capital movement of baht 199.8 bn with a current account deficit of baht 156 bn. Since 1988 the government and state enterprises have been repaying their external debts. Portfolio and direct investment provided a relatively steady inflow, but, more ominously, private short term inflows have increased sharply throughout 1990. The major part of these flows are loans to private enterprises. As will be shown presently certain aspects of Thailand's foreign exchange and interest rate policies made these flows both inevitable and undesirable.

THAILAND: CHART 1
REAL GDP, EXPORTS AND IMPORTS GROWTH



THAILAND: CHART 2
TRADE, CURRENT AND CAPITAL ACCOUNTS



Money Growth, Interest and Exchange Rates

A comparison of Charts 1 and 3 shows that the acceleration in the growth rate of money in Thailand started in the middle of 1986 when GDP growth rates were also rising, with steep increases of lending to industry lasting until the middle of 1989. Credit expansion was primarily demand driven, given the successively higher GDP growth rates achieved from 1986 to 1988. The rate of growth of M2 peaked in August 1990 when the effects of the Gulf crisis started to slow down bank lending. The deceleration in money stock growth continued since then, with preliminary estimates for February 1991 putting the rise of M2 at 22.5% yoy.

The net capital inflows shown in Table 1 should have caused the exchange rate of the baht to appreciate, despite the growing trade and current account deficits. Since 1988 the authorities, however, have chosen to maintain the nominal exchange rate within a narrow band of 25-26 (baht) to the USD (Chart 4).

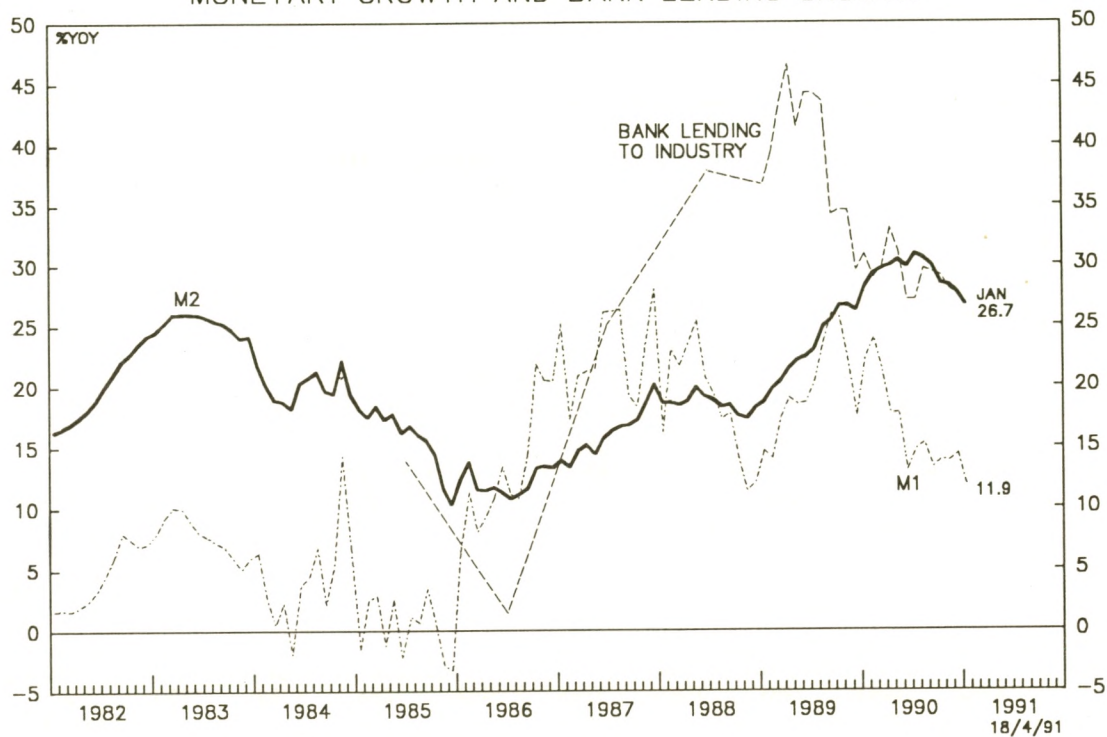
Interest rates on all bank deposits (except some savings accounts) are now decontrolled and determined by market forces. The authorities still impose ceilings on commercial bank lending rates although these ceilings are not interpreted as "recommended" levels but as maximums, and are treated as such by the commercial banks. As Chart 5 shows the ceiling lending rate in Thailand had stayed unchanged for nearly four years (1986-89). In March 1990 the rate was raised from 15 to 16.5%. In November 1990 it was raised again to 19% where it stands now. Actual lending rates, however, have now started to decline. In February 1990 they were reduced to 16% from nearly 17% and in April 1990 fell again to 15%. Meanwhile interbank rates had been on an upward path from the beginning of 1987 until January 1991 propelled by the buoyant demand for credit and the rapidly expanding economy. The slowdown in loan demand after the Gulf crisis exerted a downward pressure on these rates, which since January 1991 have started to decline (Chart 5).

The widening gap between Eurodollar and Thai interbank rates since 1989 Q2 continues to cause considerable difficulties for the Thai authorities. Given the relative stability in the nominal exchange rate of the baht, the widening interest rate differential has been an open invitation for arbitrage funds. As the data in Table 1 indicate by the middle of 1990 the inflow of these funds was becoming large enough to force the authorities, as early as March of that year, to impose a 15% tax on foreign borrowing by Thai entities in order to discourage these activities. The tax is still in force but the differential even now is wide enough to make arbitrage still a profitable proposition.

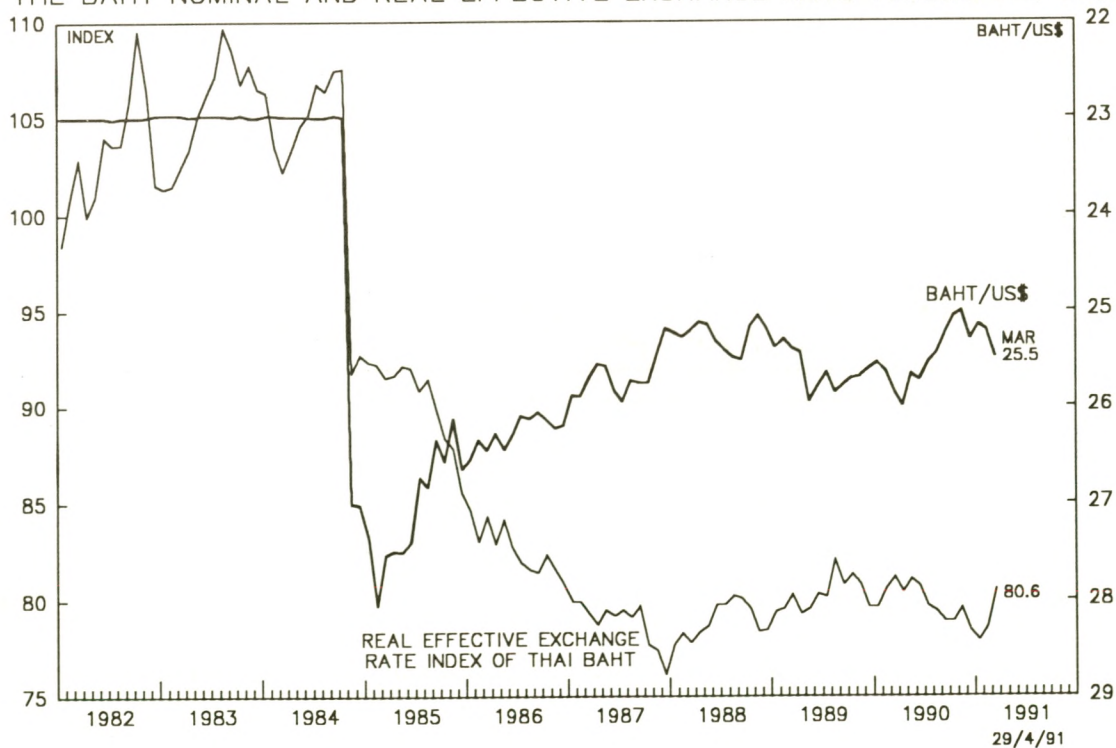
In sum, the combinations of a policy which capped the movements of the exchange rate, a booming economy which attracted foreign investment, and, until recently, rising short term interest rates propelled by strong credit demand resulted since the start of 1989 in sharp increases in the rate of growth of money.

The impact of foreign capital inflows on the domestic money stock can be quantified by analysing its contribution to the growth of the monetary base. The Bank of Thailand defines monetary base as the sum of private currency holdings and deposits of banks with the central bank. Chart 6 shows that since 1986 the foreign component of the monetary base has been continuously positive. The increasingly negative contribution of the domestic component (the foreign and domestic compo-

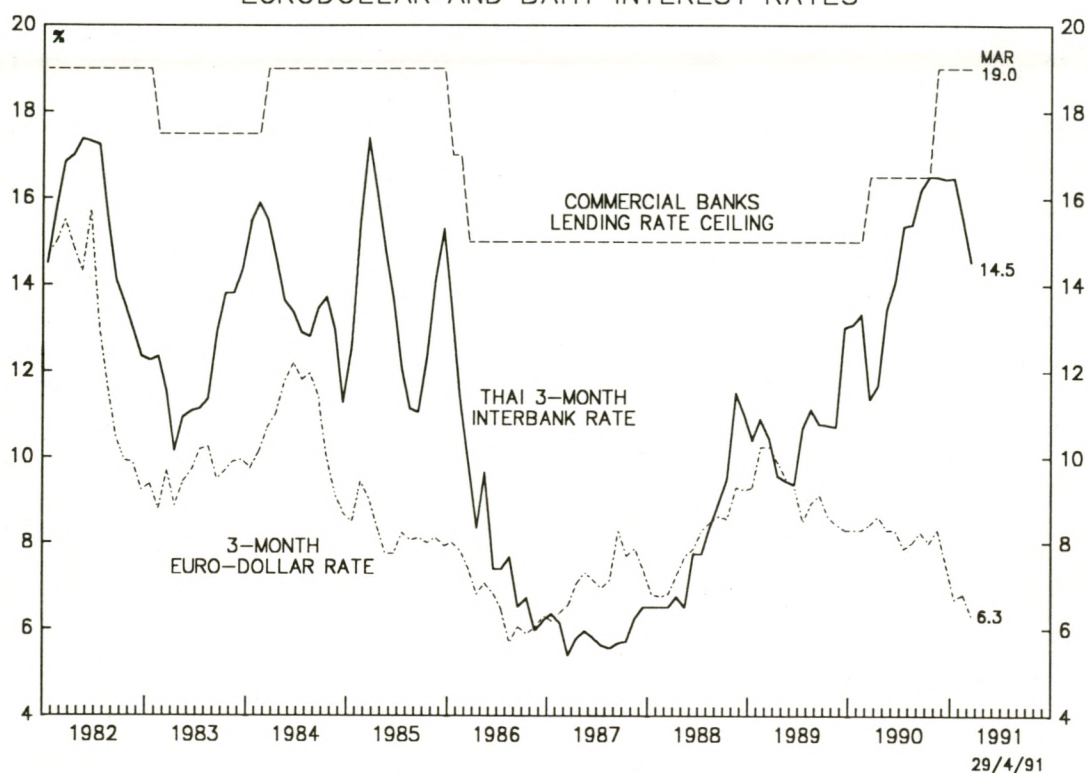
THAILAND: CHART 3
MONETARY GROWTH AND BANK LENDING GROWTH



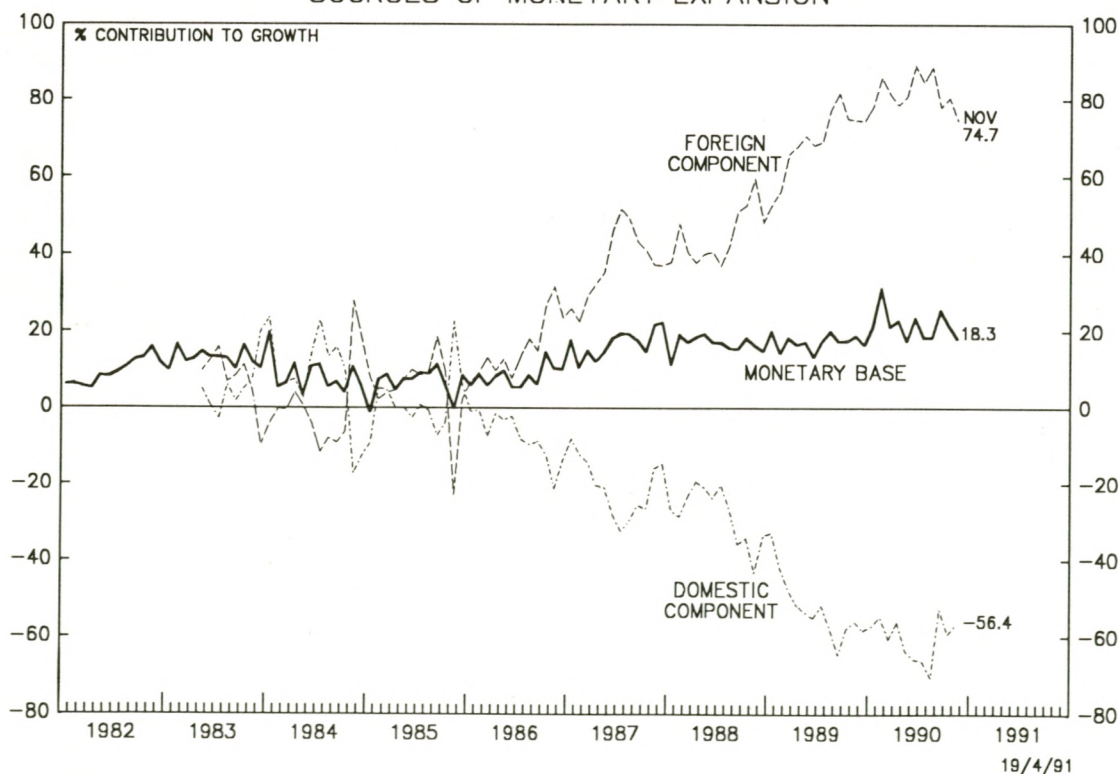
THAILAND: CHART 4
THE BAHT NOMINAL AND REAL EFFECTIVE EXCHANGE RATE VERSUS THE US\$



THAILAND: CHART 5
EURODOLLAR AND BAHT INTEREST RATES



THAILAND: CHART 6
SOURCES OF MONETARY EXPANSION



nents adding up to the actual percentage increase of the base) was the result of the growth of government deposits with the Bank of Thailand. This was a direct consequence of the fiscal policies pursued since 1988. The impact of these policies on monetary developments will be analysed in greater detail both in the text and in the technical appendix to this article. At this stage it is sufficient to point out that had it not been for the negative contribution of the domestic component, the monetary base would have grown much faster and this would have permitted a faster growth of money stock.

The Role of Fiscal Policy

Table 2 shows that since 1988 the Thai authorities have run up a fiscal surplus most of which was used to repay the domestic government debt. The rest of the surplus, plus assorted nonbudgetary funds, was accumulated in government deposits with the Bank of Thailand (Table 3). During September 1990 there was a sudden upsurge in domestic borrowing by the government to the tune of baht 23.4 bn from the Bank of Thailand. This explains the reversal in the trend of net repayments of the domestic debt during 1990 (Jan-Sept). In view of the rising budget surplus this would appear to be a contradictory action. During the same month of September, however, the state repaid baht 18.7 bn of the foreign debt. The upsurge in the domestic lending might have been a simple exercise in cash flow smoothing as the government used the proceeds of the domestic loan to purchase foreign exchange with which to repay part of its external debt. The treasury surplus for September 1990 of baht 18.5 bn matched almost exactly the net repayment of foreign loans of baht 18.7 bn. There is therefore no reason to believe at this stage that the authorities have reversed their policy in using part of the budget surplus to repay the domestic national debt.

Since 1988, the year that a fiscal surplus appeared, the size of government deposits with the central bank both in relative and absolute terms increased at exceptionally fast rates (Table 3). Towards the end of 1990 government deposits accounted for 82% of total central bank deposits as opposed to 22% in 1983. Also the amount of government bonds held by the Bank of Thailand both in absolute terms and as percentage of total assets declined. Table 3 also shows for comparison the absolute amount of government bonds held by commercial banks and as percentage of their total assets. The importance of government bonds in their portfolios declined continuously since 1986. In absolute terms, however, commercial banks still remain the most important holders of government bonds, accounting for over 60% of the sums outstanding.

In the case of Thailand the impact on liquidity and growth of the money stock of the accumulation of government deposits with the central bank and of the redemption by the authorities of government bonds since 1988, was, in general, contractionary. As the Appendix shows increases in government deposits with the central bank reduces the monetary base. Also the repurchases of bonds can, under some circumstances, have either a neutral or a contractionary effect on the monetary base as well.

In other words had it not been for the negative monetary impact of fiscal policy the acceleration in the growth of money since 1988Q2 would have been significantly higher and the inflationary pressures commensurately stronger.

The budget presented for 1991-92 by the interim military government is aiming

Table 2

Government Finance (Baht bn)

	Budget Deficit (-) Surplus (+)	Net Domestic Borrowing (Repayment)	Net Foreign Borrowing (Repayment)
1985	-38.9	31.5	14.1
1986	-34.1	50.2	(6.4)
1987	-8.8	10.6	(3.2)
1988	+36.0	(28.8)	(4.5)
1989	+65.3	(11.1)	(6.1)
1990	+44.3	(0.9)	(9.5)
(Jan-Sept cumulative)	+96.6	18.3	(36.9)

Table 3

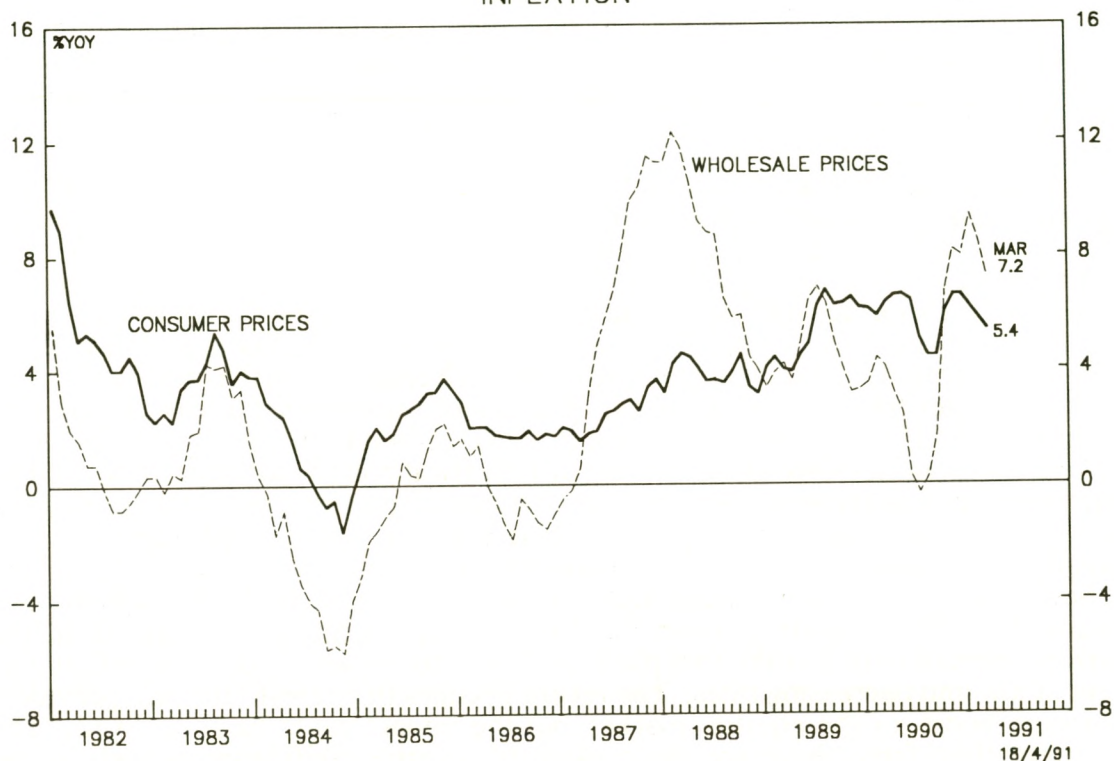
Government Deposits with and Government Bond Holding of the Bank of Thailand

	1983	1984	1985	1986	1987	1988	1989	1990 (Sep)
Government Deposits								
1. Total (baht bn)	2.8	3.1	5.5	7.6	6.6	11.9	54.5	133.5
2. As percentage of total liabilities	1.5	1.6	2.4	3.0	2.3	4.0	15.0	28.0
3. As percentage of total deposits	22.4	24.6	28.0	32.2	24.7	33.8	70.4	82.3
Government bonds								
1. Total (baht bn)	61.9	58.2	62.5	61.5	58.9	33.9	21.3	32.1
2. As percentage of total assets	33.2	29.1	27.9	24.6	20.8	11.2	5.8	6.7

For the sake comparison the following are the figures of government bond holdings of commercial banks

Total (baht mn)	51.8	74.6	76.9	102.3	114.9	123.1	121.2	113.8
total assets	9.6	11.4	10.7	13.1	12.1	10.7	8.4	6.6

THAILAND: CHART 7
INFLATION



at no deficit or a modest surplus.

On past experience fiscal projections in Thailand have tended to err on side of caution and this budget may well end up yielding a substantial surplus. Indeed the present budget for 1991-92 allows for baht 27.9 bn in repayments of domestic and foreign debt and therefore this figure can be taken as the expected “working surplus” of the authorities’ estimates.

As Chart 7 indicates inflationary pressures might be far from over in Thailand, particularly as the rise in money growth between 1989-1990Q2 may well be impacting on prices right to the end of 1991. The declining trend of exports since 1989 Q2 will not be helped by any loss of competitiveness, and ominously, the Real Effective Exchange Rate for the baht started to turn up in 1991 (Chart 4). This index shows that the trade and inflation weighted exchange rates for the baht against a basket of currencies is now rising, causing an erosion of Thailand’s competitiveness.

The ability of the authorities to keep the nominal exchange rate within their chosen band of baht 25-26 to the USD will be put to the test if any further deterioration in the current account deficit weakens foreign investors’ confidence. As the data in Table 1 indicated short term capital inflows are now predominating in the balance of payments and, by their nature, could easily and quickly become outflows. The recent trend in falling interest rates is likely to add weight to these considerations since the arbitrage gains between baht and USD interest rates will get smaller and the perceived foreign exchange risks bigger.

The Thai authorities are apparently unconcerned over the potentially mounting inflationary pressures. The decreases in the growth of money stock since August 1990 could be reversed as lower interest rates encourage borrowing and the immediate impact of the Gulf crisis recedes. Therein lies the danger of another sharp increase in monetary expansion without the assurance of a tighter, rather than just neutral, fiscal policy which held back the rate of growth of money during 1989-1990 Q3.

Conclusions and Forecast: Lower interest rates in Thailand since the start of 1991 signified falling demand for credit rather than a deliberate easing by the authorities. However, in view of the inflationary pressures still to manifest themselves, following the rapid expansion in money stock during 1989-90 Q3, the worsening current account deficit and the short term nature of the net foreign capital inflows, a confidence crisis over the baht could easily occur towards the end of 1991 Q3. Fiscal policies during 1988-90 generated sufficient budget surpluses which ensured that the credit expansion during that period was held in check. The interim nature of the current military government in Thailand and the promise to hold elections by the spring of 1992 means there is no guarantee that during the rest of 1991 fiscal policies will remain tight. The military government could attempt to spend its way to an electoral victory during the current year. A falling fiscal surplus, or worse a deficit, would simply fuel monetary expansion. This will hasten the day of reckoning for the current account deficit which is becoming progressively insupportable in terms of the capital flows which have financed it. The potentially overvalued baht, which permitted the growth of the current account deficit in the first place, will need to be devalued unless inflation is kept at low and decreasing rates. The recent declines in interest rates will provide a welcome boost for the equities market, but the impact could be short-lived. The countervailing forces here are the erosion of investor confidence as well as the questionable stability of the rate of exchange of the baht.

APPENDIX: The Monetary Impact of Fiscal Surpluses

As this article indicated monetary expansion in Thailand during 1989-1990 Q3 would have been considerably larger had it not been for the restraining influence of the fiscal surpluses since 1988.

This appendix examines in greater detail the technicalities of the monetary impact of fiscal surpluses (and by extension of deficits). The analysis is quite general and does not apply to Thailand only, although the illustrations are drawn from the material in this article.

The accumulation of a surplus signifies that the state acquires a net sum of bank deposits from the personal and corporate sector. The state may hold deposits with either the central bank or commercial banks or both.

In the case of deposits held with commercial banks, the accumulation of the surplus simply leads to a shift from deposits of the public to that of the state. As long as there are no special liquidity or reserve requirements imposed on state deposits with commercial banks, there will be no impact on the banks themselves. As state deposits with the banking sector are sometimes excluded from the definition of money, the accumulation of these surpluses could lead to a slowdown in the measured growth of money stock.

In the case where the state holds deposits with the central bank only, the accumulation of the surplus will have a direct impact on commercial banks. As the deposit holders of these banks write out tax cheques in favour of the government, the banks will honour them by asking the central bank to transfer an equivalent amount out of the banks' own deposits with the central bank and credit them to the government's account. In the process of doing so two things will happen.

Firstly the overall balance sheet of the commercial banks will shrink because on the liabilities side clients deposits will decline and on the assets side the banks' deposits with the central bank will also decrease. As the deposits of the banks with the central bank are invariably part of their liquid and reserve assets (and a part of the monetary base) the accumulation of the budget surplus, all other things remaining equal, will lead to a liquidity squeeze and therefore to higher short term rates.

Secondly, the balance sheet of the central bank will remain unchanged since on the liabilities side all that has happened was a switch from deposits of the banks to those of the government.

Once the state starts to accumulate deposits either with the central bank or with commercial banks or both, there are a number of options open to it as to the use of these surpluses.

The most obvious and simple one is that these surpluses are spent. All the processes just described are reversed and any impact on liquidity is temporary.

The second option is for the government to reduce its domestic debt by buying back its bonds. There are three possible cases here to examine. The bonds can be purchased either from the central bank, or commercial banks or the public. The case of repurchasing foreign debt is examined separately.

If bonds are redeemed from the central bank then, all other factors remaining constant, the central bank's overall balance sheet is reduced as its liabilities (state deposits) decrease by the same amount as its assets (government bonds). The overall impact is contractionary in the sense that the state deposits are eliminated and they do not recirculate to become part of the monetary base.

The case of repurchasing bonds from commercial banks is slightly more complicated. The government will pay for these bonds either by drawing down its deposits with commercial banks (if it holds any) or with its deposits with the central bank. In the first case the overall balance sheet of the commercial banks will be reduced. Their liabilities (state deposits) will decrease by the same amount as their assets (government bonds). There should be no impact on banks' liquidity but interest rates could fall as government bond prices rise.

In the second case where the government uses its deposits with the central bank to pay for the bonds, the banks will simply have their assets reshuffled. Government bonds will decrease but deposits with the central bank will rise. Liquidity would have increased and interest rates eased.

Finally the government could repurchase its bonds from the public. Again the way the government pays for them is of importance. If the government uses its deposits with commercial banks the impact on the banks would be neutral. Private depositors will have more deposits and the government less. To the extent that the public is now holding more liquid assets and its deposits are reclassified as part of the money stock, overall liquidity in the economy has increased. If the government pays by drawing down its deposits at the central bank and crediting the commercial banks' account with the central bank, then the banks will have their balance sheets expanded. Their deposits will increase by an amount equal to the bonds sold to the government, and their assets by the amount transferred by the state to their accounts with the central bank.

In the case of Thailand the government has been repurchasing its debt primarily from the central bank but also in modest sums from the banking sector (Table 3). As this Appendix has illustrated, repurchasing bonds from banks has a neutral or expansionary effect depending as to how the payment is effected. Repurchasing from the central bank has a net contractionary effect. As the amount of bonds held by commercial banks has remained relatively unchanged since 1988, the year of the first surplus, the overall impact of the developments analysed so far has been contractionary. This is also indirectly confirmed by the negative contribution of the domestic sector to the growth of the monetary base (Chart 6).

There is finally the issue of the repayment of the external debt.

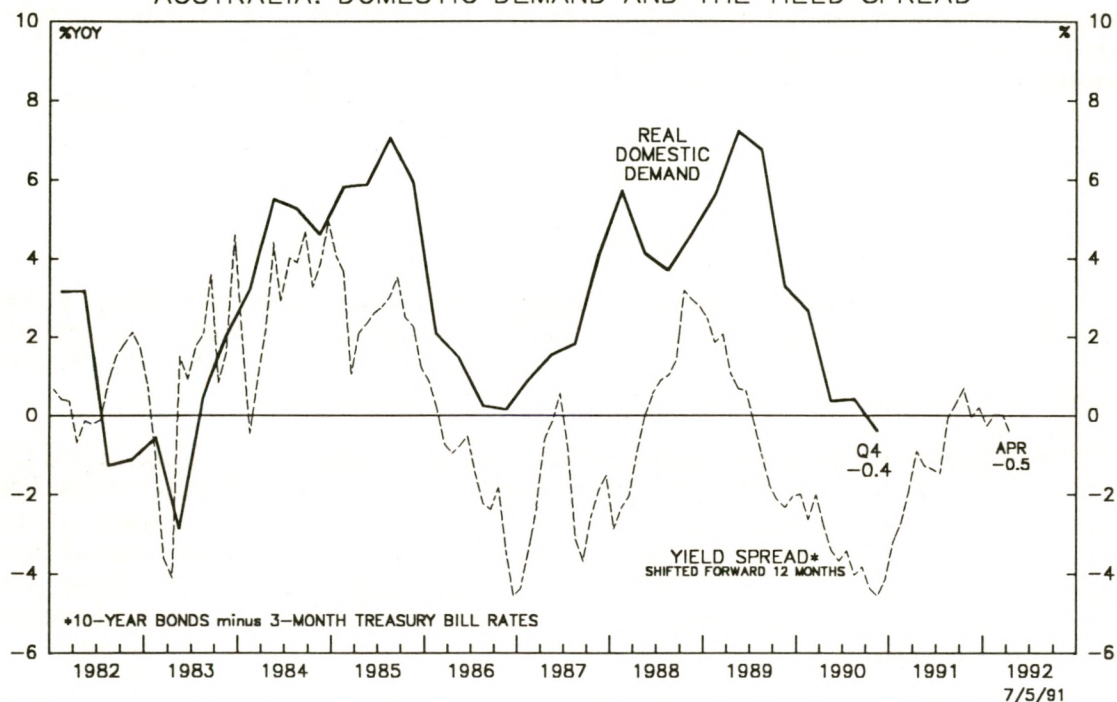
The state can use its accumulated surplus to purchase foreign exchange either from Thai or non-resident entities, both of them assumed to be nonbanks. In both cases these entities will have more baht deposits with banks and fewer foreign exchange holdings.

The government has two options as to how to effect payment. Either it will use its deposits with the central bank or its deposits with commercial banks. In the first case commercial banks will have their liquid assets increased and the monetary base will expand. In the second case the banks will simply have the ownership of their deposits reshuffled. There will be no effect on liquidity or in the monetary base. The net effect of these actions on money stock and liquidity in the economy is therefore neutral to expansionary.

AUSTRALIA: STILL IN RECESSION BUT SOME GOOD NEWS IS EMERGING

CHART 1

AUSTRALIA: DOMESTIC DEMAND AND THE YIELD SPREAD



On May 16th 1991 short term interest rates fell by another 100 bps to 10.5%. As Chart 1 shows the yield curve in Australia became progressively flatter throughout 1990 as short term interest rates kept decreasing. These lower rates should have had a positive impact on demand by 1991 Q1. The April unemployment figure, however, which stood at 9.9%, up from March's 9.2%, indicates that the economy is still weak.

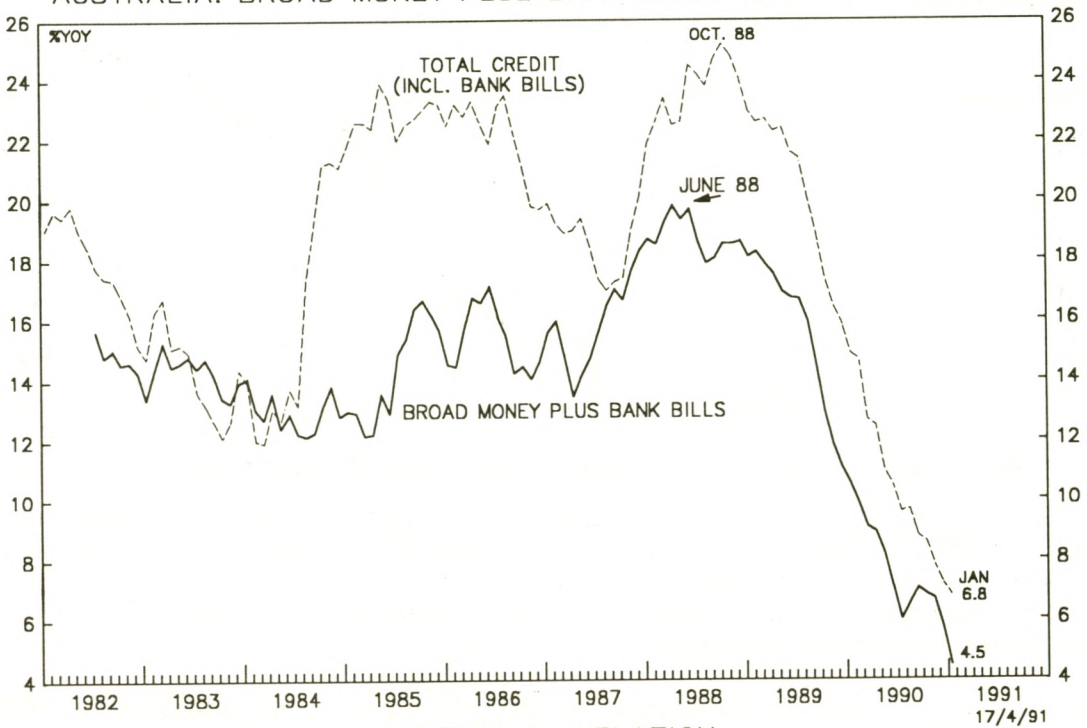
Monetary growth (Chart 2, upper panel) shows as yet no signs of revival. Inflation rates, however, were lower for 1991 Q1, at 4.9% yoy, down from the oil price boosted level of 1990 Q4 (Chart 2, lower panel). The rejection by the Industrial Relations Commission of a government-unions wages pact was also good news for short term inflation trends. It was bad news, however, for labour market efficiency as it delayed the progress towards decentralised wage negotiations.

On the brighter side, however, the current account deficit decreased to A\$1.20 bn during March from A\$1.45 bn in February. The improvement was primarily due to falling imports, a further sign of a weak economy. Another development with long term implications was the government's Statements on Industrial Policy in mid March. These proposals included reductions in the tariff levels imposed on cars, textiles, clothes and shoes as well as reductions in agricultural etc. assistance schemes and several other fiscal and tax adjustments. The tariff reduction proposals are the most important part of this package as they will boost competition and efficiency in the sectors involved and directly benefit consumers.

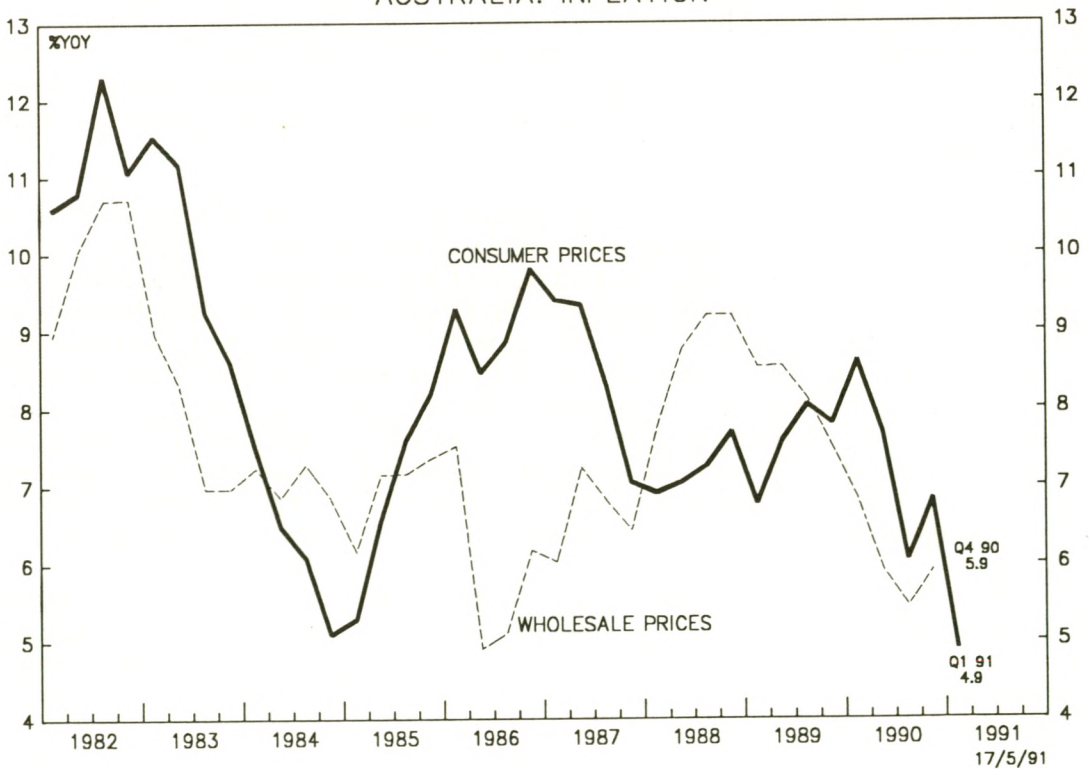
The recovery of the Australian economy continues to be painfully slow although the fall in inflation and interest rates had a positive impact on equities.

CHART 2

AUSTRALIA: BROAD MONEY PLUS BANK BILLS AND TOTAL CREDIT

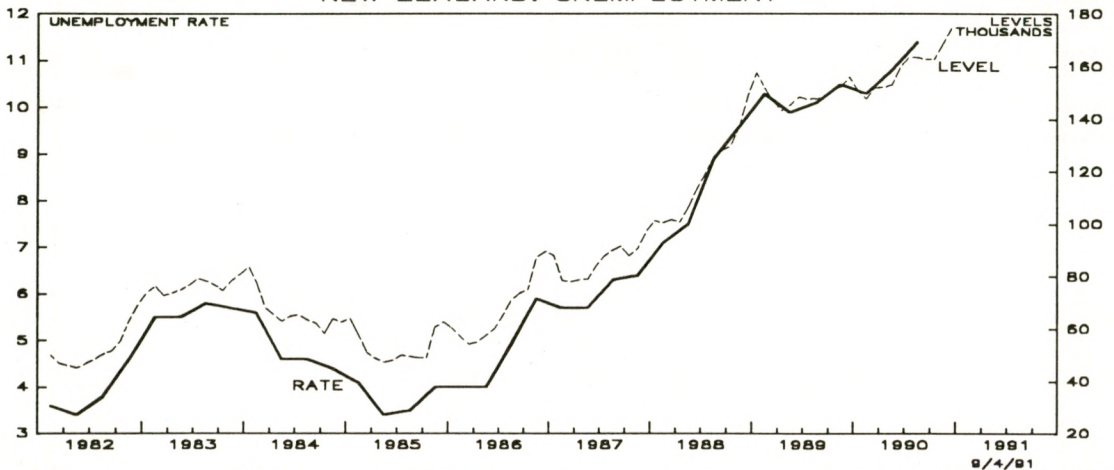


AUSTRALIA: INFLATION



NEW ZEALAND: LABOUR MARKET REFORM - THE LAST PIECE IN THE JIGSAW OF DEREGULATION

NEW ZEALAND: UNEMPLOYMENT



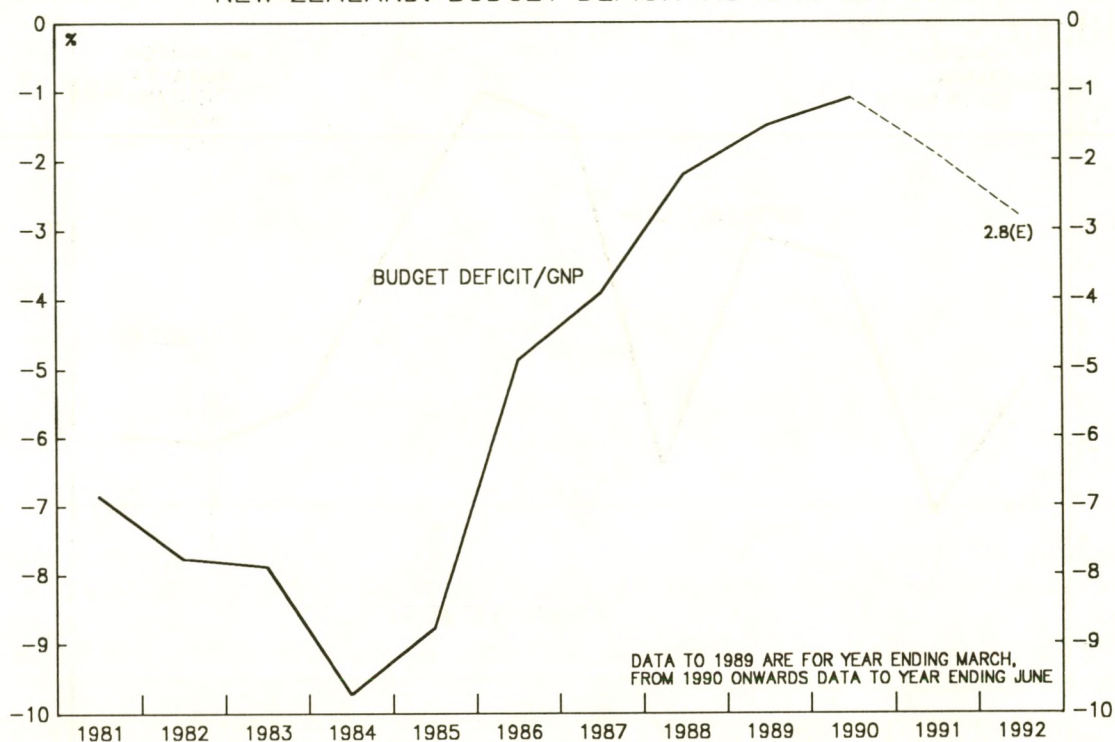
On May 1st, the 1987 Labour Relations Act was superseded by the Employment Contracts Bill, thus breaching the final bastion of economic regulation and protectionism. Political line had prevented the previous Labour administration from dismantling New Zealand's inflexible industrial relations framework, despite the party's admirable deregulation programme.

New Zealand has traditionally been a low unemployment country and over the 1970s and early 1980s, the unemployment rate rarely exceeded 6%. However, in recent years, the number of jobless has climbed and now stands at record highs. This can be explained by the decision of Labour to switch its policy target from full employment to low inflation, and to open up the economy to the forces of international competition. Nevertheless, the labour market has been slow to adjust, and productivity and wage flexibility gains have remained disappointing.

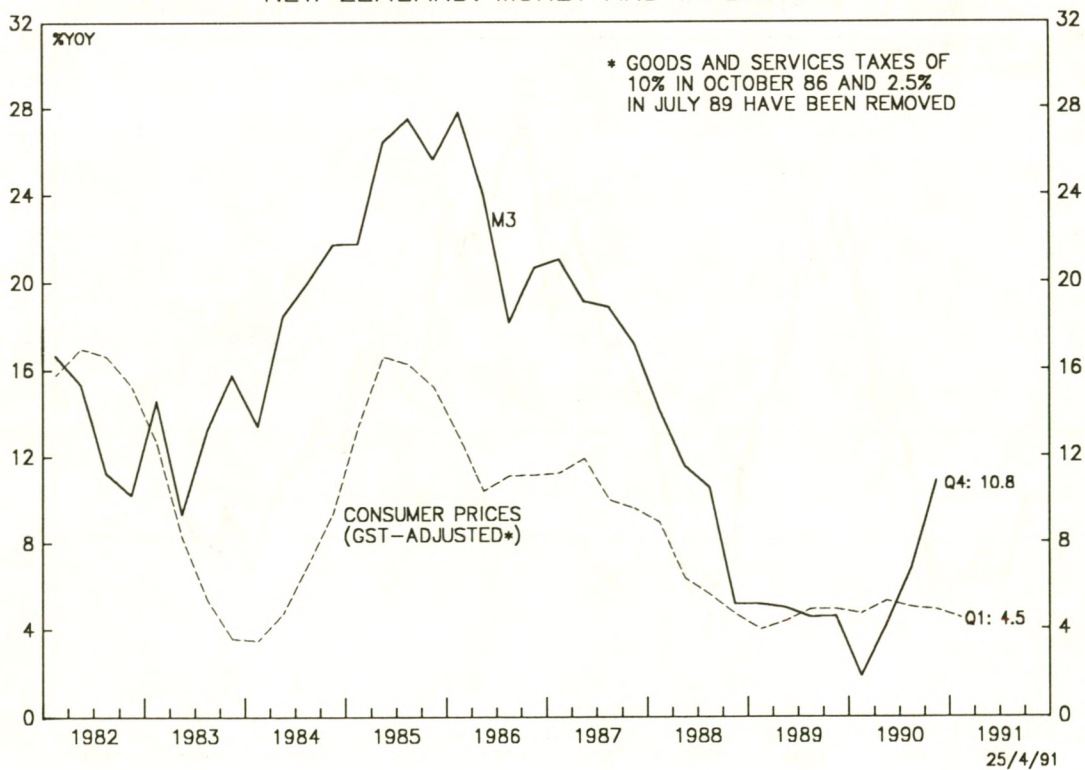
The new Employment Contracts Bill should change call of this. Compulsory union membership has been ended and an individual will now be able to negotiate his own employment contract. This replaces the system of blanket coverage which attempted to assign specific rates of pay for specific jobs, and thus tended to preclude bonuses and productivity-related payments. In tandem with these reforms, the government has also introduced a package of welfare cuts primarily aimed at trimming the budget deficit, but also with labour market reform overtones. The cuts in welfare payments are expected to reduce expenditure by NZ\$2.2 billion during fiscal 1991-92, restricting the deficit to 2.8% of GNP. Savings will be made in social service and superannuation expenditure, while unemployment benefit has been lowered to well below the minimum wage and will now be dependent on a claimant's availability for work.

Fiscal tightening at this stage will put a further damper on consumer expenditure exacerbating the current recession. However, monetary policy is slowly being eased and inflation is trending down towards its 0-2% target by the end of 1993. Add to this, these serious new attempts at labour market reform and deficit reduction, and the New Zealand economy is looking fit, lean and reded for a rebound as and when the world economy recovers. On the downside, the lack of real gains in reducing agricultural protectionism at a global level will continue limit New Zealand's potential growth.

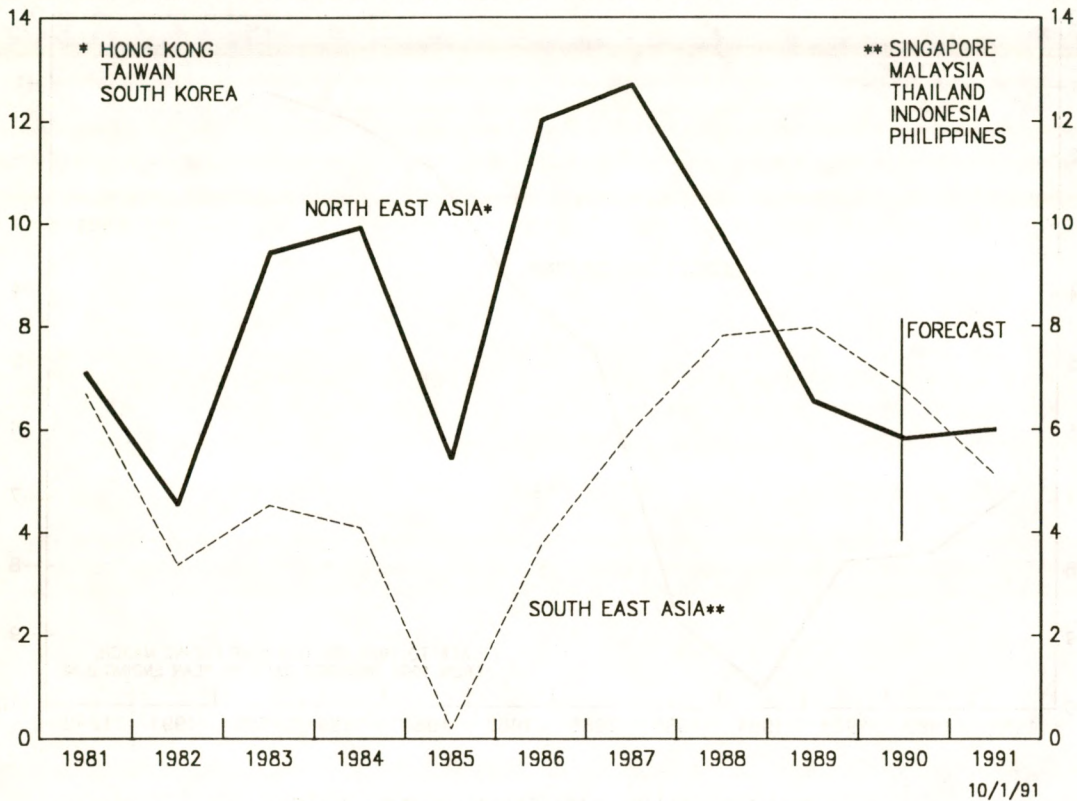
NEW ZEALAND: BUDGET DEFICIT AS % OF GNP



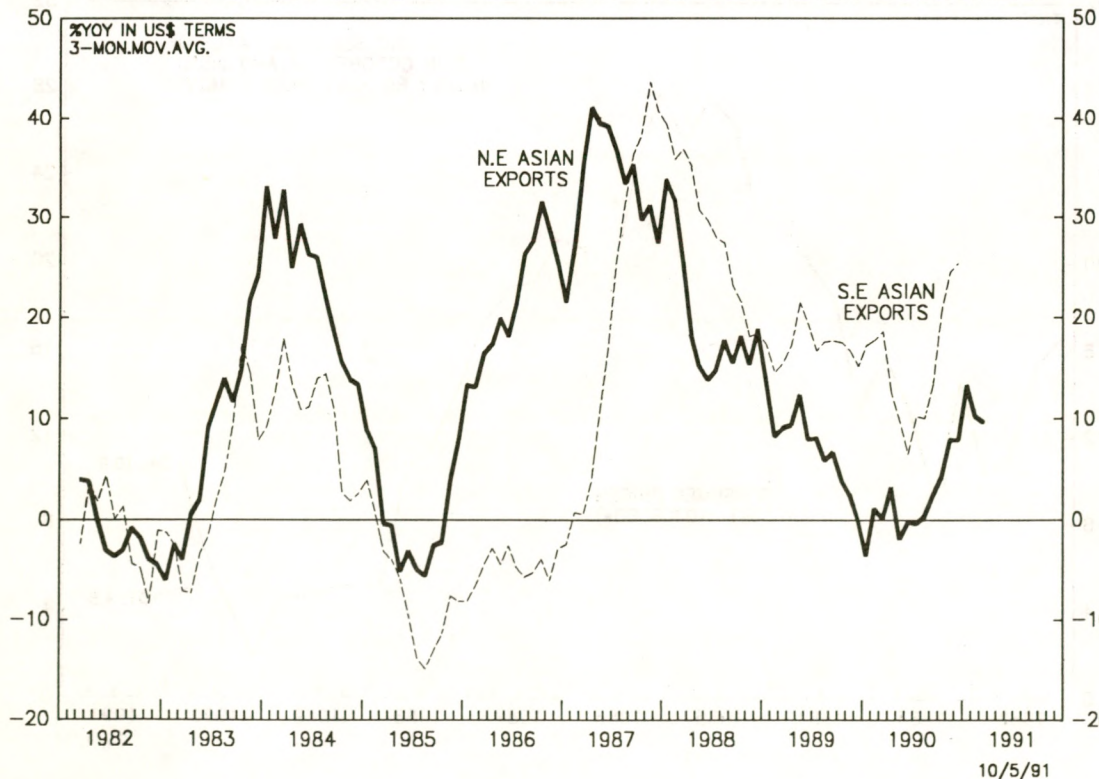
NEW ZEALAND: MONEY AND INFLATION



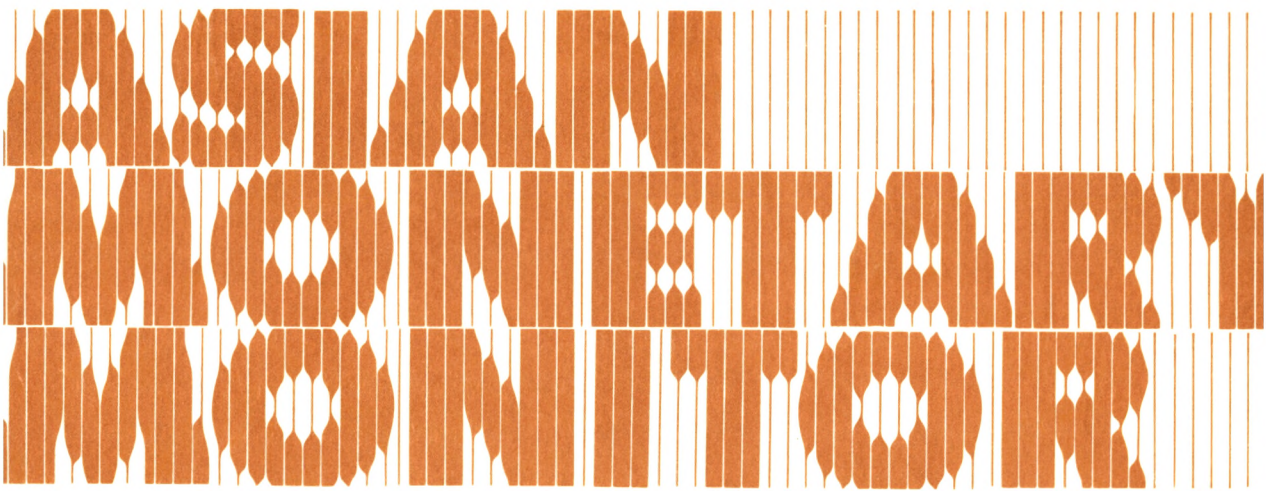
REAL GDP WEIGHTED GROWTH RATES OF NORTH EAST AND SOUTH EAST ASIA



GROWTH OF EXPORTS OF N.E ASIAN AND S.E. ASIAN ECONOMIES







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JAPAN

WHEN WILL THE MONETARY SLOWDOWN IMPACT THE ECONOMY?

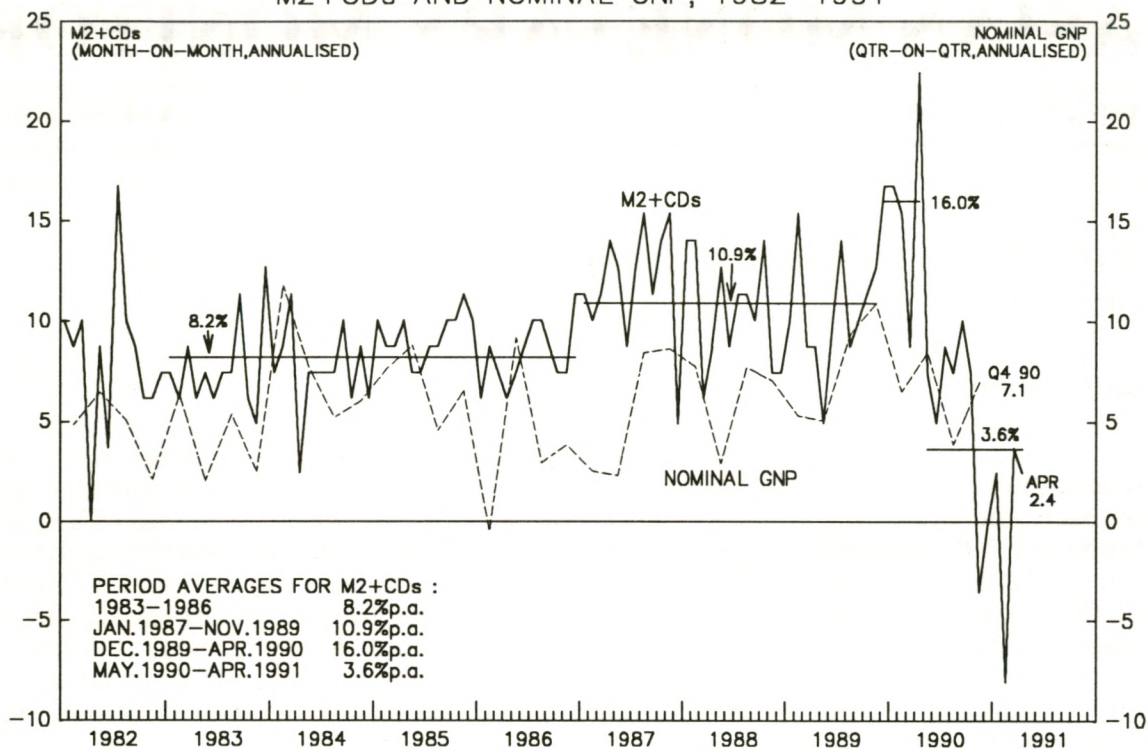
Introduction.

Since mid-1990 Japan has experienced an abrupt monetary slowdown, more severe than any in the postwar period. However, since the economy was already very buoyant and there was ample liquidity (as measured by the ratio of M2 + CDs to nominal GNP), it is taking an unusually long time for the monetary slowdown to have any impact on real economic activity. This paper first explains the nature and extent of the so-called "monetary overhang", then examines the consequences of three possible time-paths for correcting the monetary overhang. The conclusion is that the monetary slowdown is likely to impact the real growth rate of the economy around the fourth quarter of 1991 unless the Bank of Japan reverts to a faster growth rate of the money supply before then.

Phases of Monetary Growth

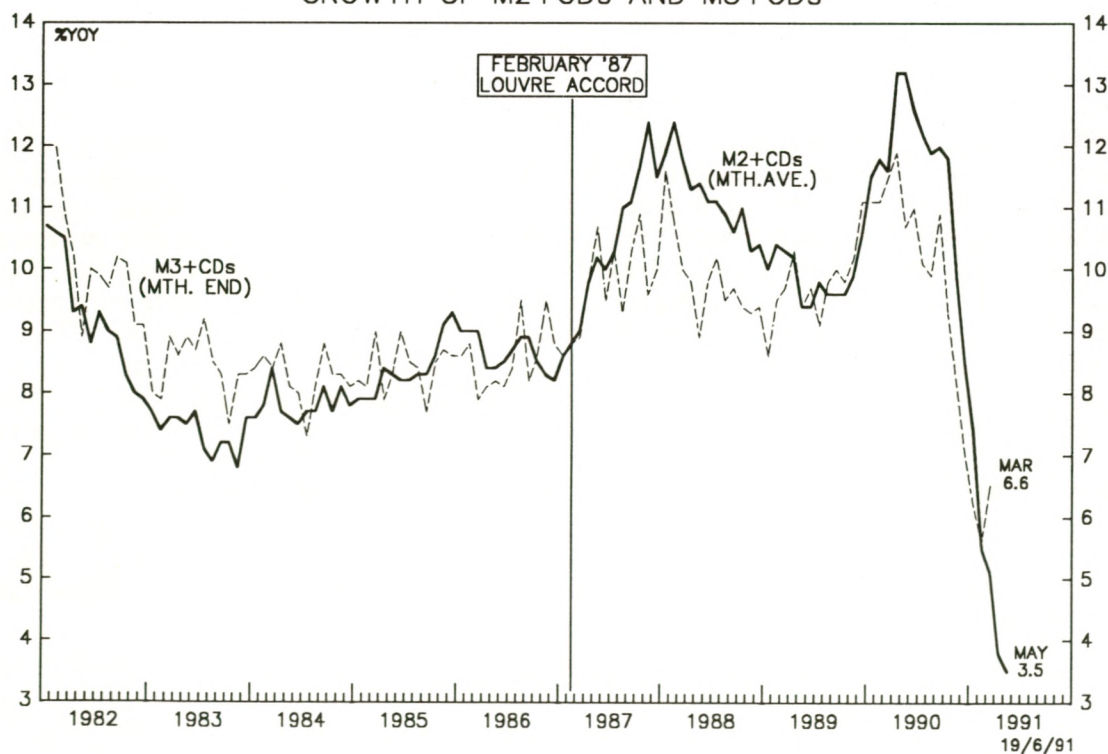
During the early 1980s the Bank of Japan pursued an exemplary policy of stable money growth. For example, between 1983 and 1986 M2 + CDs grew at a steady 8.2% p.a. with very little deviation from this average (see Chart 1). However, starting in 1987 domestic monetary policy was seriously disrupted by the commitment given by the Japanese authorities to peg the Yen/US dollar rate at levels which required the Bank of Japan to buy large quantities of dollars. The purchase of dollars was matched by the issue of large quantities of Yen, which showed up in Japan's banking system as a rapid credit expansion and a substantial acceleration in monetary growth. Thus between 1987 and 1989 M2 + CDs grew at an annual rate of 10.9%, though with rather more variability around this average than had been experienced in 1983-86. Then in December 1989 and during the first four months of 1990 Japan witnessed a sudden surge in monetary growth which took M2 + CDs to an annual rate of 16.0% (see Chart 1 again) before the new Bank of Japan Governor, Mr. Mieno, succeeded in re-establishing monetary control in the latter part of the year. Subsequently money growth has slowed abruptly in two phases. Between May and October 1990 M2 + CDs grew at an annualised rate of 7.7%, and between November 1990 and April 1991 M2 + CD growth slowed even further, actually declining at a rate of -0.5% p.a. Over the year May 1990 to April 1991 M2 + CDs has grown at the extraordinarily low rate (for Japan) of 3.6% p.a.

JAPAN: CHART 1
M2+CDs AND NOMINAL GNP, 1982-1991



14/6/91

JAPAN: CHART 2
GROWTH OF M2+CDs AND M3+CDs



19/6/91

Nature and Extent of the Monetary Overhang

The Monetary overhang in Japan has two distinct components - the rapid growth of money between early 1987 and November 1989, and the strong surge in money growth between December 1989 and April 1990. The 1987-89 acceleration of M2 + CDs and its consequences have been explored in an earlier issue of AMM (Vol. 14 No. 3, May-June 1990) so here we focus on the more recent surge in money growth. There are two sets of explanations for the monetary explosion of late 1989 to early 1990. The first, and -- in our view -- less plausible, explanation relates to a large-scale transfer of deposits from the Postal Savings System to the banks. Back in 1980-81 interest rates in Japan were at extremely high levels, and the Postal Savings System, which was regulated by the Ministry of Posts and Telecommunications, was able to offer 10-year and other term deposits at highly favourable rates. The banks, which were regulated by the Ministry of Finance, were not able to offer such attractive rates. However, in recent years, with the partial deregulation of the banking system during the 1980s and the freeing up of some deposit interest rates, the banks are much better able to compete with other financial intermediaries, offering competitive market returns. As the 1980-1990 10-year fixed term deposits at the Postal Savings System matured, therefore, many individuals reportedly transferred these lump-sum deposits from the Postal Savings System to the banks. Statistically this meant a transfer from M3-type deposits to M2-type deposits, which some commentators have seized on as an explanation for the surge in M2 + CDs in early 1990.

The problem with this explanation is that it overlooks the parallel surge in M3 + CDs in the early months of 1990. If there had been only a shift in deposits from M3 + CDs to M2 + CDs then the M2 + CD definition would have shown a marked increase while the M3 + CD definition would have continued to grow at roughly the same rate as in late 1989 i.e. about 9%. In fact M3 + CDs also accelerated to almost 12% (year-on-year) between December 1989 and April 1990. This parallel acceleration of M2 + CDs and M3 + CDs in early 1990 is shown in Chart 2 and casts doubt on the validity of the deposit-transfer thesis.

The second and more satisfactory explanation for the surge in money growth in early 1990 is that businesses and individuals began to expect interest rates to rise sharply after the fall of the Berlin Wall in November 1989, as indeed they did. It was widely perceived (wrongly, in our view *) that there would be a global capital shortage as a result of the need to reconstruct Eastern Europe, and hence there emerged a widespread expectation that interest rates in Japan and elsewhere would stay high for a sustained period of time. As a result, Japanese firms hurried to obtain new loans or secure enlarged credit limits so as not to be shut out when the capital shortage arrived. Such surges in loan demand have occurred in past episodes ahead of a monetary

= = = = =

* In truth, the capital shortage is a myth. The former communist countries can create a huge amount of capital (gross savings) by privatisation, and by introducing free market pricing and the rule of law. Only reforms of this kind will create the incentives for individuals and firms to save and accumulate capital. Without these reforms western businessmen will not wish to invest in these countries anyway; even with these reforms the ability of these countries to borrow or attract investment will be strictly limited by their relative poverty and hence their inability to repay debt or generate dividends.

tightening in Japan (e.g. in 1973), so the 1990 episode of credit expansion accompanied by monetary acceleration was not the first of its kind. The net result was an acceleration in bank lending and money growth of roughly the same magnitude, and therefore a need by the Bank of Japan to raise short term rates even further in order to regain its grip on credit expansion. Indeed, not only did the Bank of Japan raise interbank call rates to 8% by the end of 1990, but they also tightened the notorious Window Guidance controls, or limits on the increments in bank lending as from the second quarter of 1990, extending them specifically to real estate lending.

Once the credit was created, the damage was done and it was very difficult to reverse it. In this particular case not only had money growth surged out of control in the first four months of 1990, but this problem had been preceded by three years of excess money growth in 1987, 1988 and 1989. Clearly there was now too much money in the economy for prices to remain stable, but how much of the total money growth in the past 3 1/2 years was excess money?

One way to measure the monetary overhang is to calculate what the quantity of money would have been if it had been maintained at a proper growth rate (i.e. a growth rate appropriate to non-inflationary growth) since late 1986, or late 1989. This approach is illustrated in Chart 3. However, this approach does not help to answer the question of how much money would have been absorbed or used up by the higher volume of transactions in the economy.

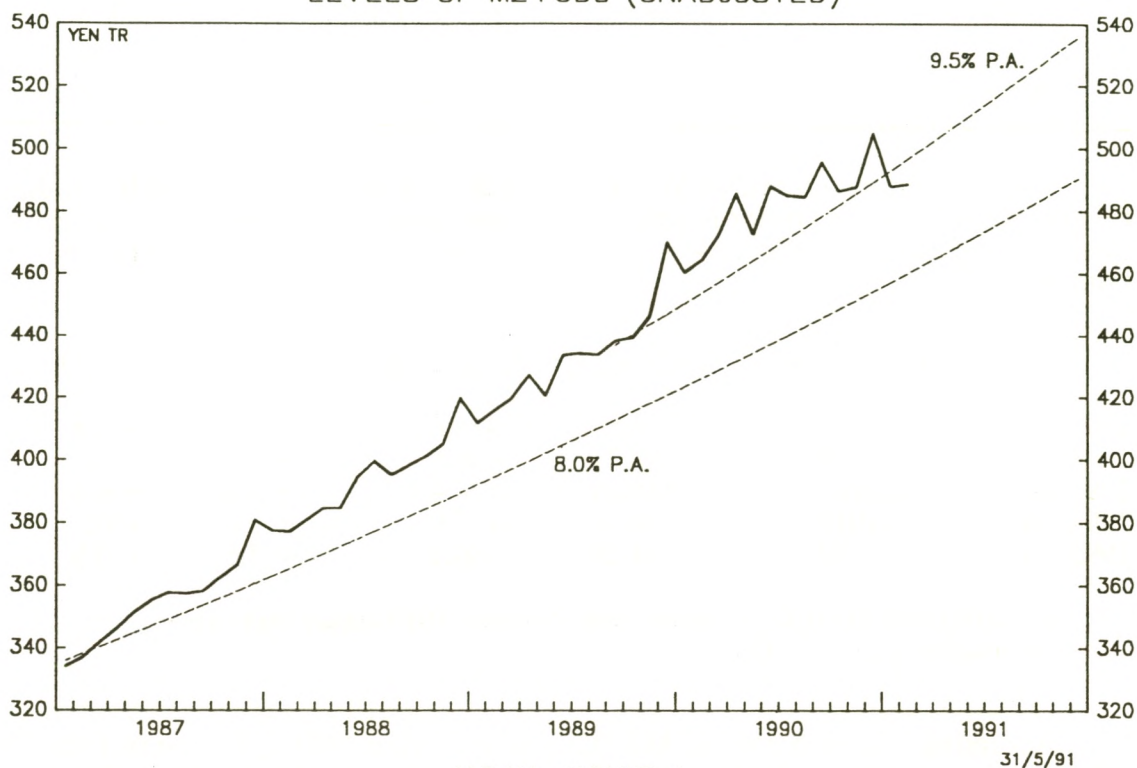
A better approach is to use Marshallian k , the ratio of the money supply to nominal GNP. Over the period 1975-90 the trend of Marshallian k is +2.7% p.a., and its trendline is illustrated in Chart 4. The actual level of Marshallian k is also shown up to 1990 Q4. At this point the deviation from the trendline was +3.7%. (At 1990 Q3 the deviation was at its maximum of +5.5%).

Time Paths for Correcting the Deviation of Marshallian k

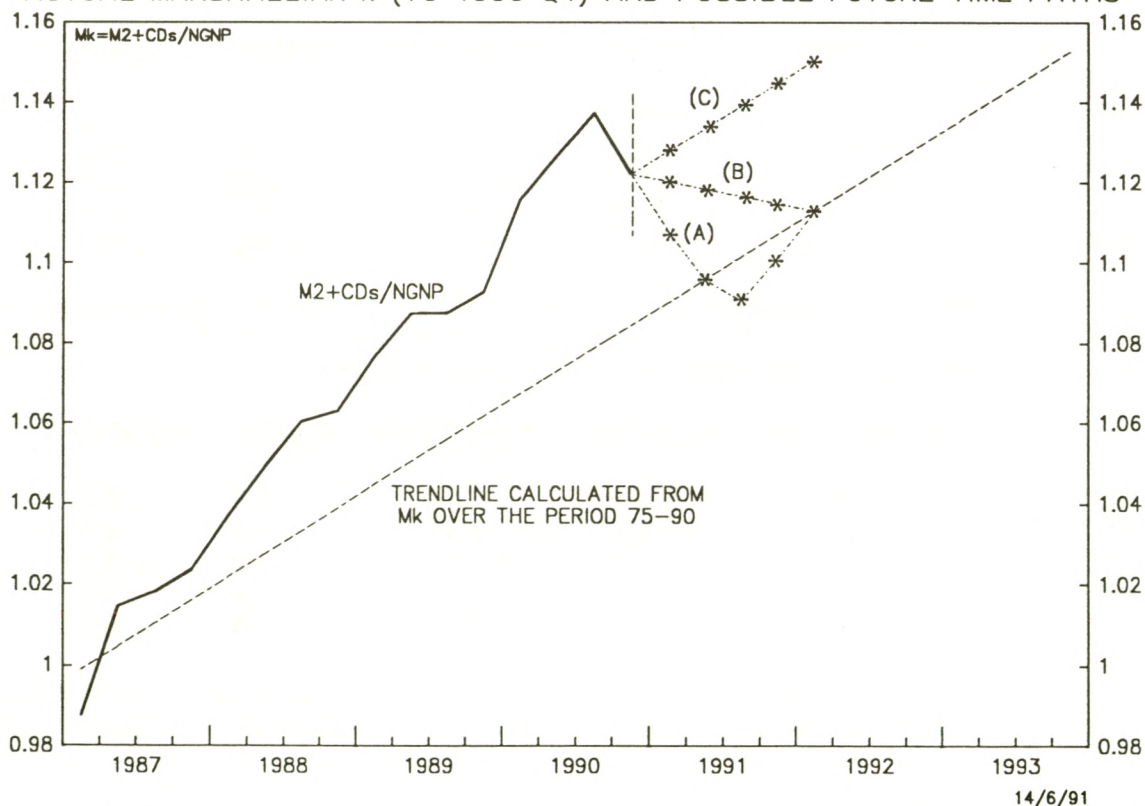
Three general routes can be hypothesised in Chart 4 for correcting the deviation of Marshallian k from its long term trend.

- (A) The Overshoot Path. Money growth remains at its current very low pace (4% p.a.) until Marshallian k overshoots the trendline and then money growth is raised progressively to enable the actual Marshallian k to return to its long term trend line within three quarters of overshooting, i.e. by 1992 Q1.
- (B) The Convergence Path. Money growth is immediately adjusted (from 1991 Q2) to a higher growth rate (8% p.a.), which was also the long-run equilibrium or non-inflationary growth rate during the early 1980s, and nominal GNP adjusts optimally to allow a gradual convergence by 1992 Q1.
- (C) The Revised Trend Path. Money growth is again immediately adjusted (from 1991 Q2) to a higher growth rate (8% p.a.), but this time there is no reversion to the old trend for Marshallian k . Instead it is assumed that there has been a vertical shift in Marshallian k to a new trend line parallel to the old one, perhaps reflecting the sudden emergence of Japan as a major financial power in the last five years, and/or the deregulation of Japanese financial markets in recent

JAPAN: CHART 3
LEVELS OF M2+CDs (UNADJUSTED)



JAPAN: CHART 4
ACTUAL MARSHALLIAN k (TO 1990 Q4) AND POSSIBLE FUTURE TIME PATHS



years, and a corresponding decision of Japanese and foreign firms and households to hold more money (onshore yen) per unit of Japanese national income.

We now explore the implications of these different time paths of Marshallian k for nominal GNP and real GNP.

Assuming a growth rate of M2 + CDs of 4% until 1991 Q2, followed by gradual reversion to 8% p.a., in order to achieve the coordinates illustrated by the asterisks along time path (A) in Chart 4 it is necessary to have the following outcome for nominal GNP :

	<u>Marshallian k</u>	<u>M2+CDs</u>	<u>Nom. GNP</u>	<u>% YOY</u>	<u>%QOQ</u>
1991 Q1	1.1080	494.80a	446.6	+ 6.8	+ 1.8
1991 Q2	1.0959	500.27	456.5	+ 6.9	+ 2.2
1991 Q3	1.0907	519.65	476.4	+ 10.6	+ 4.4
1991 Q4	1.1013	526.27	477.9	+ 9.0	+ 0.3
1992 Q1	1.1130	534.28	480.1	+ 7.5	+ 0.5

a = actual data; M2+CDs are assumptions; Nominal GNP data are implied by Marshallian k and M2+CDs.

Assuming a growth rate of M2+CDs of 8% from 1991 Q2, then in order to achieve the coordinates illustrated by the asterisks along time path (B) in Chart 4 it is necessary to have the following outcome for nominal GNP :

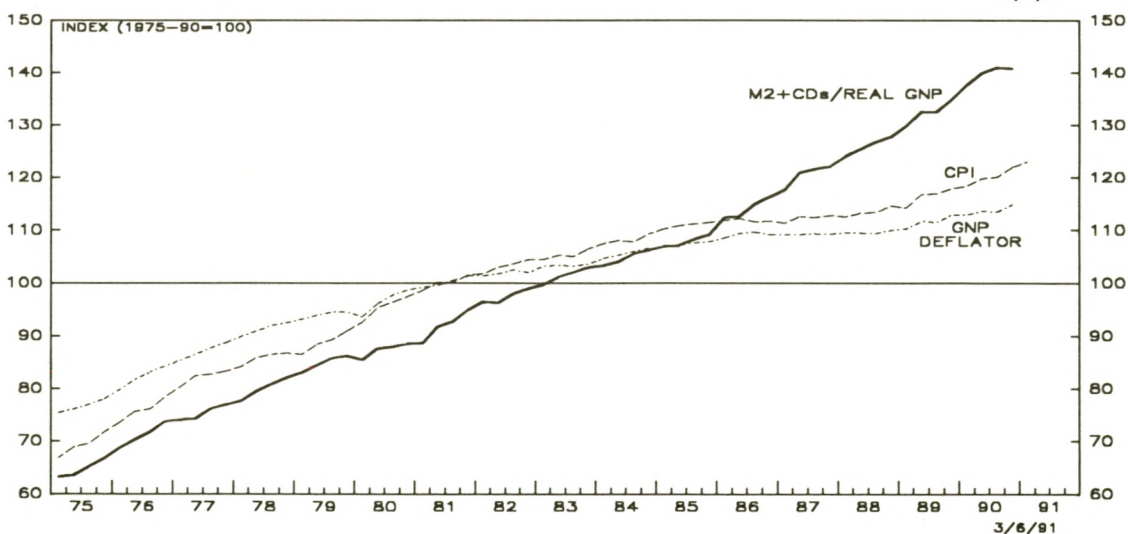
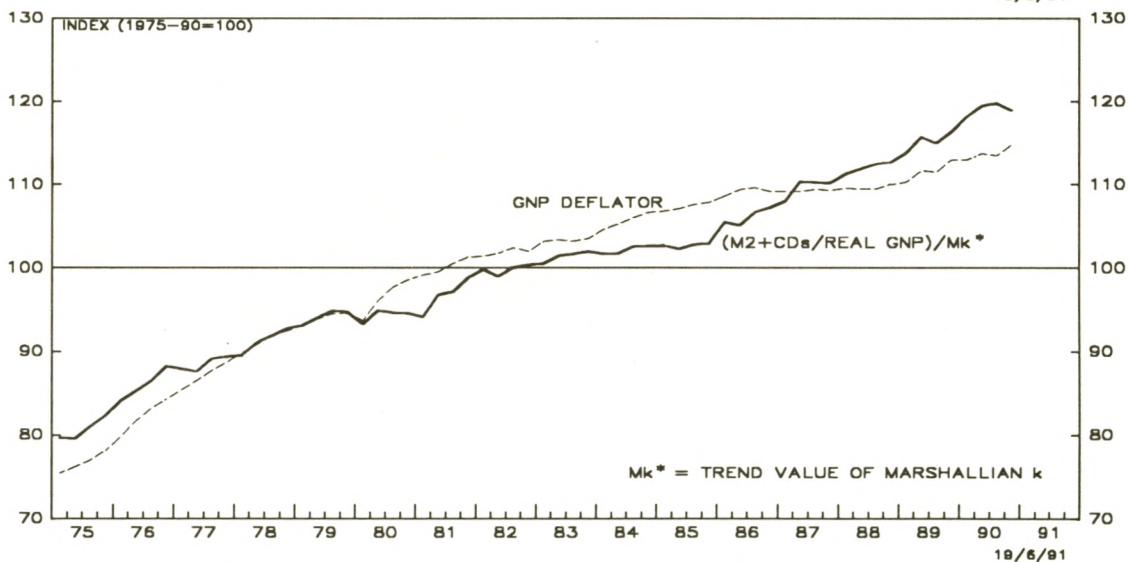
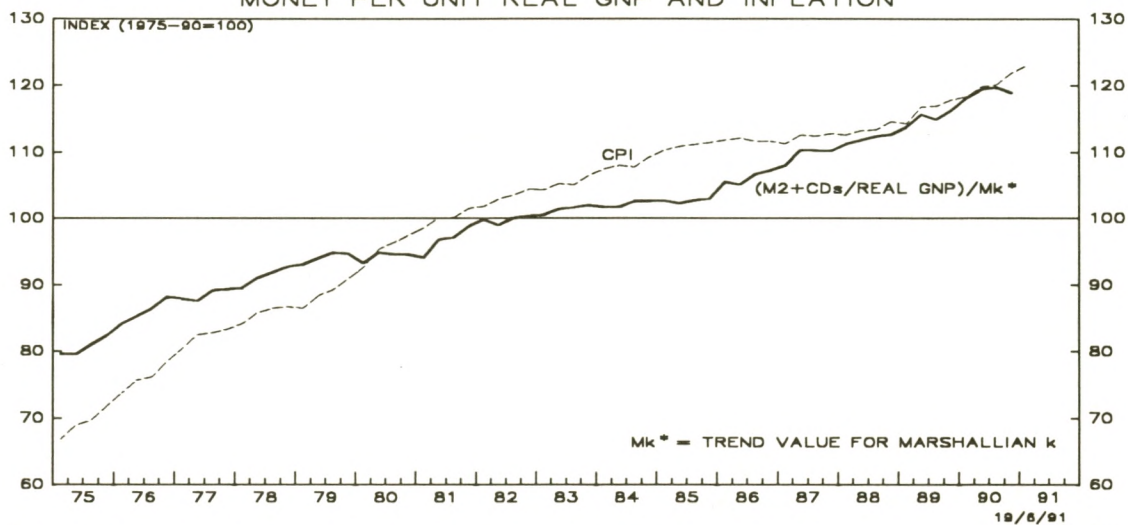
	<u>Marshallian k</u>	<u>M2+CDs</u>	<u>Nom. GNP</u>	<u>%YOY</u>	<u>%QOQ</u>
1991 Q1	1.1203	494.8	441.7	+ 5.6	+ 0.8
1991 Q2	1.1185	519.5	464.5	+ 8.8	+ 5.2
1991 Q3	1.1166	529.5	474.2	+ 10.0	+ 2.1
1991 Q4	1.1148	531.2	476.5	+ 8.7	+ 0.5
1992 Q2	1.1130	534.4	480.1	+ 8.7	+ 0.8

Assuming again a growth rate of M2+CDs of 8% from 1991Q2, then in order to achieve the coordinates illustrated by the asterisks along time path (C) in Chart 4 it is necessary to have the following outcome for nominal GNP :

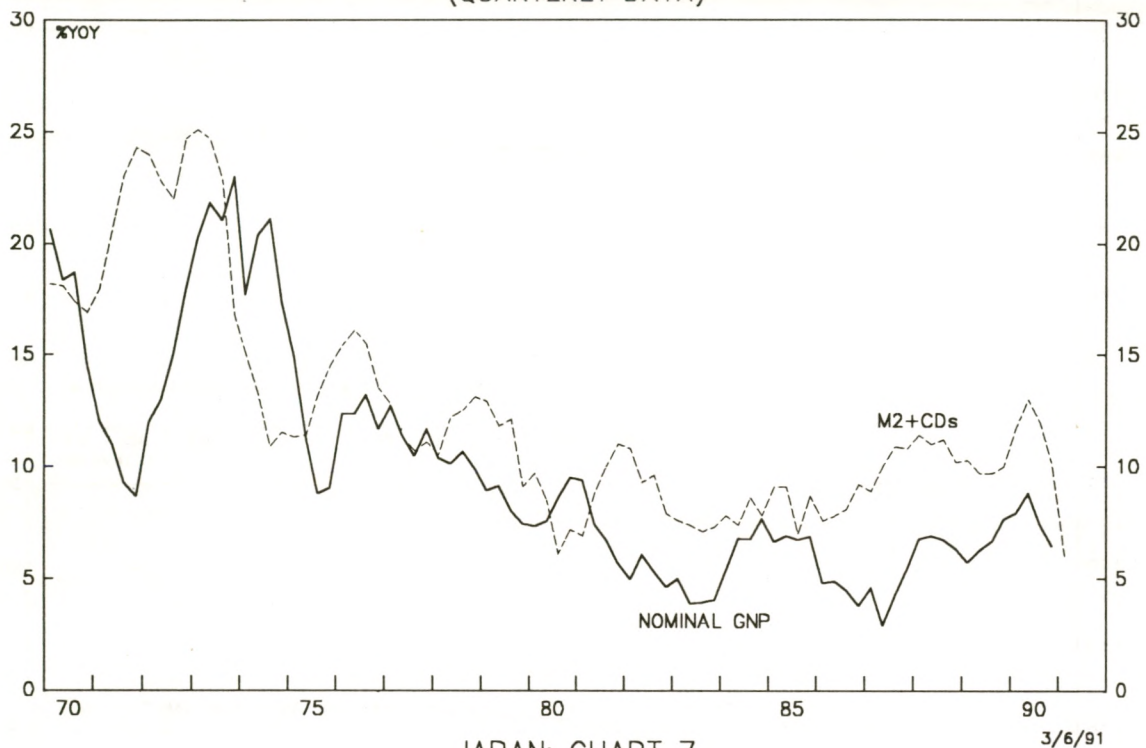
	<u>Marshallian k</u>	<u>M2+CDs</u>	<u>Nom. GNP</u>	<u>%YOY</u>	<u>%QOQ</u>
1991 Q1	1.1279	494.8	438.69	+ 4.9	+ 0.1
1991 Q2	1.1335	519.5	458.33	+ 7.4	+ 4.5
1991 Q3	1.1392	529.5	464.78	+ 7.9	+ 1.4
1991 Q4	1.1449	531.2	463.96	+ 5.8	- 0.2
1992 Q1	1.1506	534.4	464.44	+ 5.9	+ 0.1

The conclusion from all three experiments with different time paths for Marshallian k is that nominal GNP is likely to slow down quite markedly on a quarter-on-quarter basis in 1991 Q4 and 1992 Q1. Note that the QOQ growth rates shown are all for nominal GNP, which implies that even with a modest assumption of a 1-3% p.a.

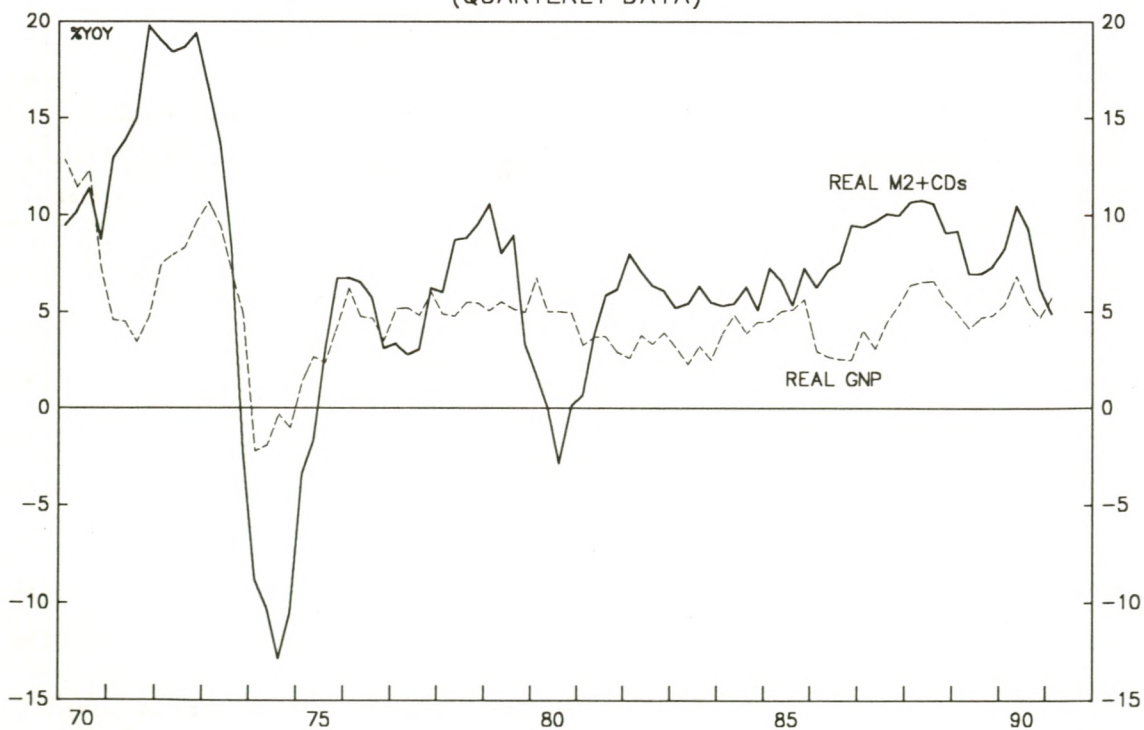
JAPAN: CHART 5
MONEY PER UNIT REAL GNP AND INFLATION



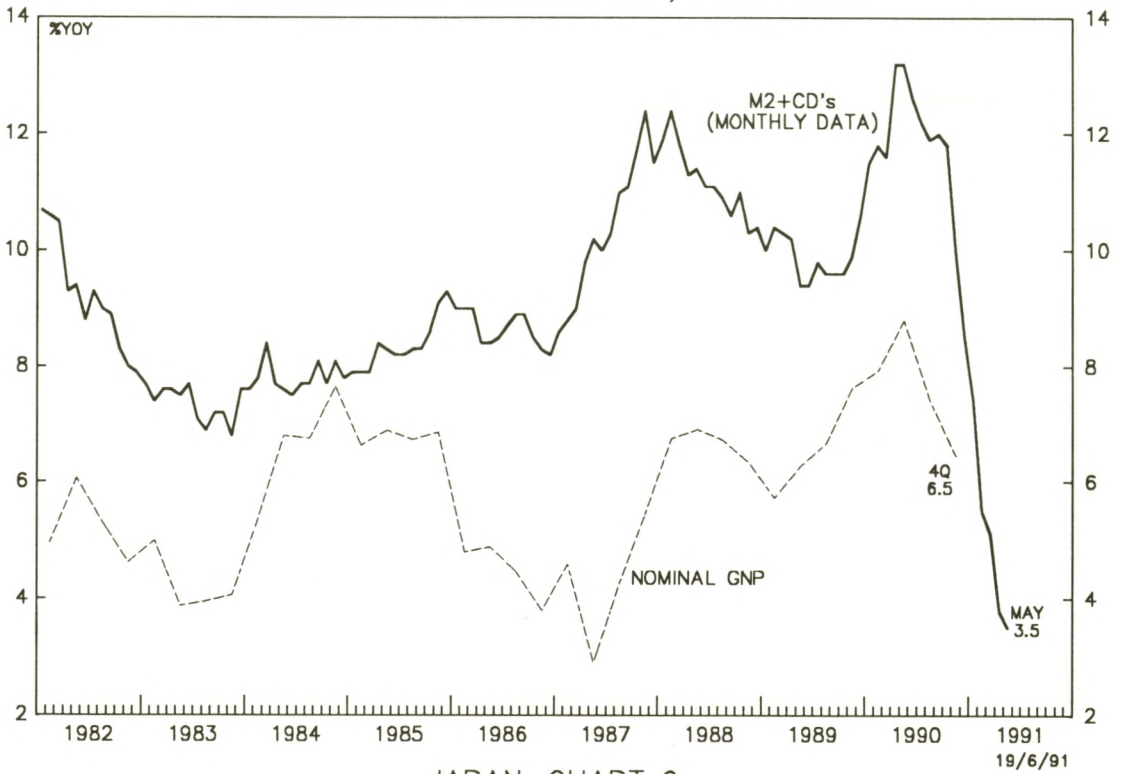
JAPAN: CHART 6
M2+CDs AND NOMINAL GNP, 1970-1991
(QUARTERLY DATA)



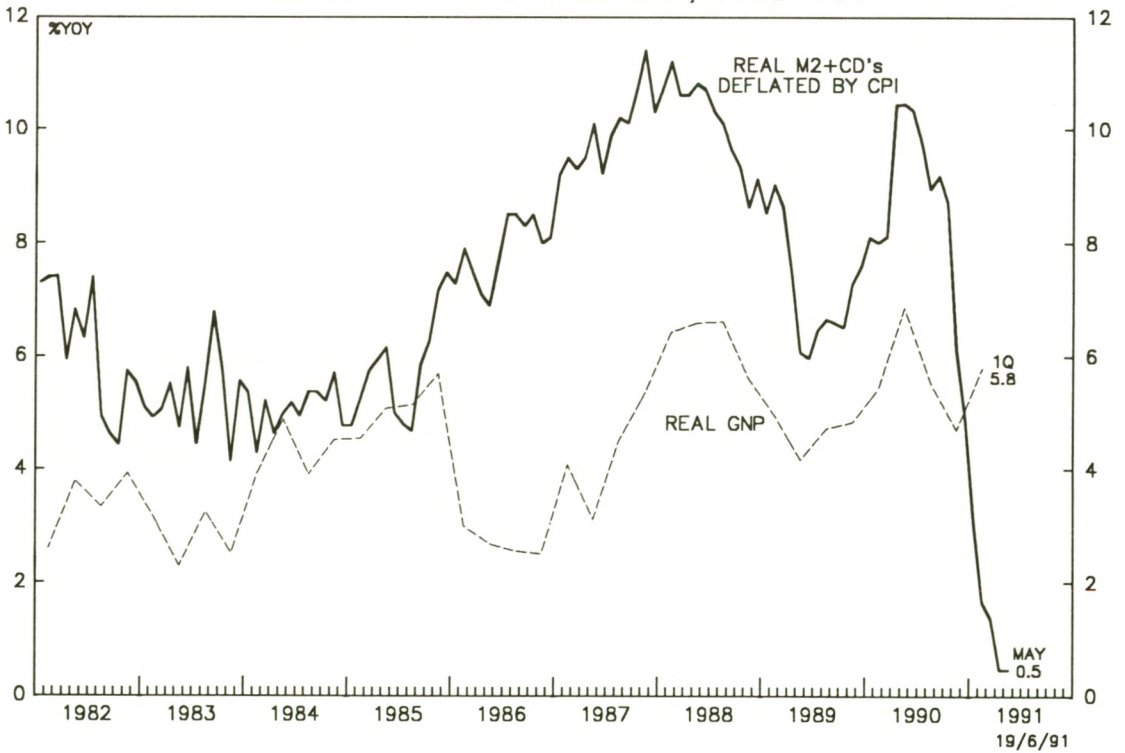
JAPAN: CHART 7
REAL M2+CDs AND REAL GNP, 1970-1991
(QUARTERLY DATA)



JAPAN: CHART 8
M2+CD's AND NOMINAL GNP, 1982-1991



JAPAN: CHART 9
REAL M2+CD's AND REAL GNP, 1982-1991



growth rate for the GNP deflator (in 1990 it was 17% for the year as a whole), the real GNP would be significantly lower. Since one would normally expect the inflationary impulse from a period of excess money growth to be reaching its maximum at an 18-24 month interval after the monetary injection, this is also the period when the deflator could be expected to be rising most strongly. This suggests that under any of these three scenarios it is not impossible to conceive of Japanese real GNP showing a negative growth rate in either 1991 Q4 or 1992 Q1.

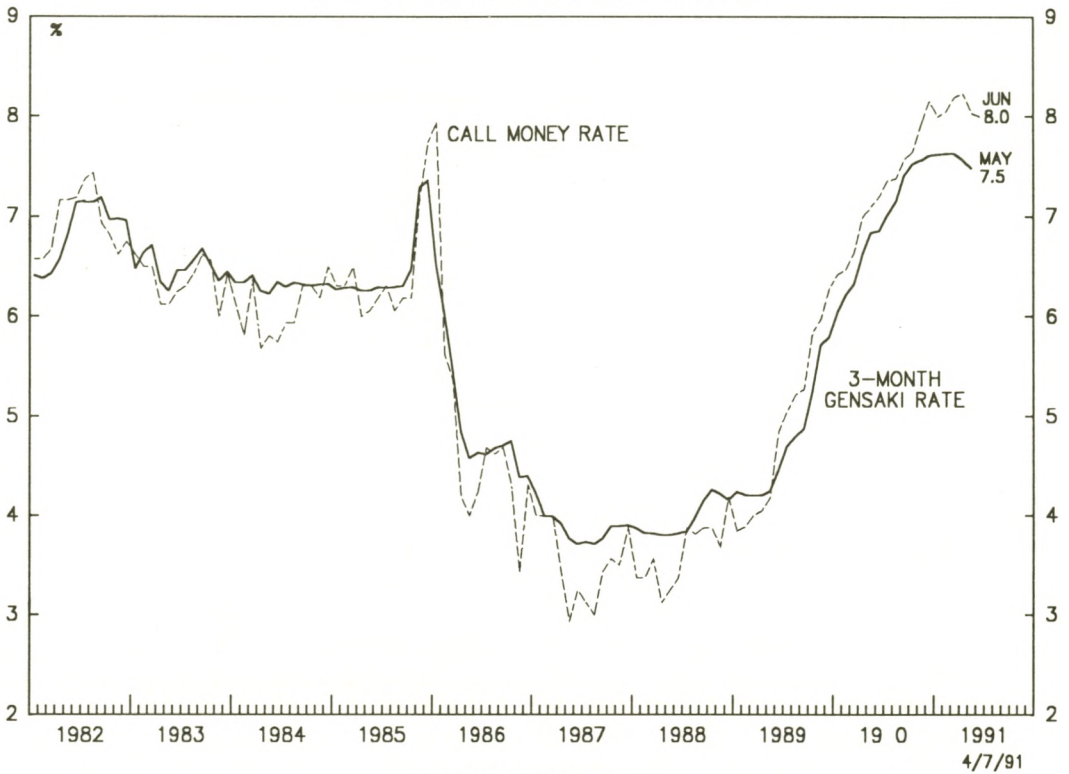
Which of the three possible time paths for Marshallian k is the most plausible?

Both (A) and (B) depend on the strong presumption that Marshallian k -- or, equivalently, its inverse, income velocity -- will return to trend at some point in the future. The basis for such a presumption is to be found in the long-standing stability of the trend of the ratio of broad money ($M2+CDs$) to the nominal GNP or equivalently the relationship between the quantity of money per unit of output adjusted for the trend in Marshallian k and the level of prices as measured by the GNP deflator or the All-Japan CPI (see Chart 5). In words, Chart 5 shows that the level of prices is very well explained over a long period of time by the amount of money per unit of output or real GNP after allowance is made for the tendency for Japanese firms and individuals to hold more money per unit of income as they have grown wealthier.

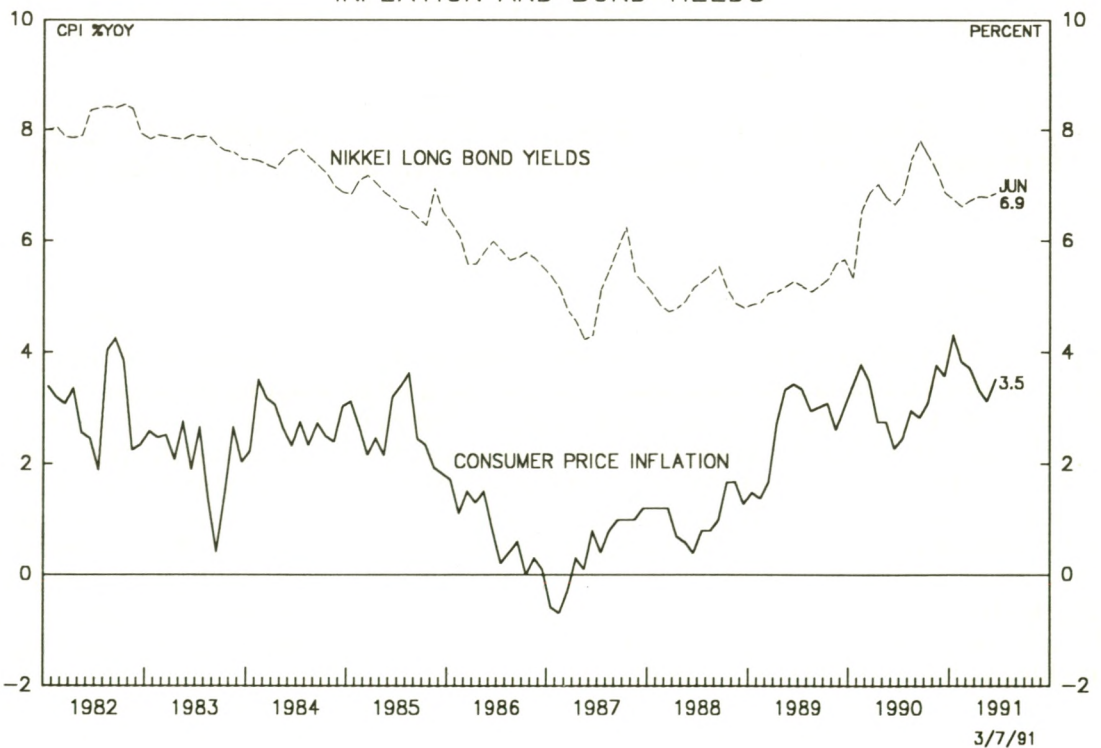
In terms of behaviour this means that if the monetary authorities act to increase the quantity of money significantly -- as they did between February 1987 and April 1990 -- the presumption of stability in Marshallian k (or velocity) implies that nominal income (total spending) will increase *pari passu* with the quantity of money. However, since there is a lag in the transmission of money growth to nominal GNP growth, i.e. people and firms take time to respond to the new, higher levels of money balances, shifts will occur in Marshallian k due first to changes in monetary growth and only later due to the response pattern of spending (GNP) to the earlier monetary changes. This is the theoretical basis for time path (A). In the past few years the more rapid rate of money growth has pushed Marshallian k upwards relative to trend, and nominal GNP has risen by most of the amount indicated by the trend in Marshallian k . In order for Marshallian k to have been on the trend line in 1990 Q3 it would have required a nominal GNP of Yen 453.93 trillion, 5% larger than the actual GNP of Yen 430.92 trillion. After averaging 5.9% p.a. between 1984 and 1987, nominal GNP has risen to an average of 6.8% (yoy) in 1988-90, but this has not been enough to bring Marshallian k back to trend. Before the faster growth in nominal GNP had fully played itself out, monetary policy has shifted again to a far lower growth rate. This has already produced the sharp shift in Marshallian k in 1990 Q4 back towards the trend line (Chart 4), and on present evidence (i.e. continued slow money growth in 1991 Q1 and seemingly strong nominal GNP growth), Marshallian k for 1991 Q1 will show another sharp shift towards trend. This suggests that path (A) is not only theoretically reasonable, but is already looking feasible in practice.

The theoretical case for path (B) depends on firms and individuals either knowing in advance, or understanding precisely the growth path of the quantity of money balances in their hands, and progressively adjusting their spending so that by 1992 Q2 they will have exactly used up the excess money balances that have accumulated since 1987. This requires that they temporarily respond more quickly (with a shorter time lag) to monetary impulses, and then revert to their old behaviour

JAPAN: CHART 10
SHORT TERM INTEREST RATES



JAPAN: CHART 11
INFLATION AND BOND YIELDS



pattern after the point of convergence in 1992 Q2, i.e. once their money balances are back to the desired level in relation to nominal income. While it may be conceivable that, given enough information, firms and individuals could respond roughly optimally to monetary policy shifts, it seems unlikely that either the monetary authorities or the banks are so dependable. On the part of the authorities we have assumed that they would need to shift immediately to an 8% p.a. money growth rate and hold that growth rate. (This would be the correct growth rate for Japan's long term trend of real economic growth of 4.8% p.a., 2.8% p.a. inflation of the GNP deflator, and 2.7% p.a. upward trend in Marshallian k). In practice this would require the authorities to lower interest rates during 1991 Q2 sufficiently to raise money growth from 4% to 8%, and then perhaps to raise rates again as that target came in sight. Similarly on the part of the banks they would need to shift from the current mandated ceilings on loan growth to increase their lending or investments at a rate which was immediately compatible with 8% p.a. money growth. It is therefore not possible to consider path (B) as theoretically plausible or as empirically likely as path (A).

Finally, path (C) implies not only a similar instant adjustment of monetary policy to the new "correct" growth path for money, but also an immediate adjustment of nominal spending to the new equilibrium rate. How could this be rationalised? In respect of money exactly the same arguments apply as above in relation to time path (B). In respect of nominal spending the implied time path would require a surge in 1991 Q2 to catch up with the assumed upswing in money growth (from roughly 4% to 8%), followed by a gradual convergence to the equilibrium rate of growth. (The negative quarter-on-quarter figure for 1991 Q4 shown in the lower table on page 6 is a result of the replication of the quarter-on-quarter patterns of sharply slower money growth in 1990 Q4 interacting with the assumption of 8% year-on-year money growth and a steady rise of Marshallian k). The two problems with scenario (C) are (i) the problem of presuming the authorities and the banks are capable of generating the required 8% money growth rate immediately, and (ii) the implication that the authorities know enough about the effects of deregulation etc. in the past five years or so to estimate correctly the new trend in Marshallian k and to ensure that the outcome of their policies hits the assumed target exactly. We therefore conclude that time path (A) is the most likely outcome both from a theoretical and from a practical perspective.

SUMMARY AND FORECAST: Normally it takes 6-9 months for changes in monetary growth to impact real GNP. However, in the case of Japan in 1990-91 the imposition of a tight monetary policy was preceded by a period of extraordinarily rapid money growth by Japanese standards. As a result a large amount of excess liquidity had built up in the economy, and consequently the impact of the slower monetary growth has taken longer to show through. This paper has approached the problem of measuring the monetary overhang by examining the deviation of Marshallian k from its long term trend, and then considering the time paths (A) and (B) by which Marshallian k might return to its former trend, or the possibility (C) that the trend of Marshallian k might have undergone an upward shift. The result of all three scenarios suggests that nominal GNP will show a significant slowdown in 1991 Q4 and/or 1992 Q1, and by implication real GNP will show a similar downturn (even assuming a roughly unchanged GNP deflator).

If the Bank of Japan is to avoid a worse outcome it will need to lower interest rates in order to stimulate money growth, starting not later than 1991 Q2 or Q3. If, however, the Bank of Japan persists with the present high interest rates through the second and third quarters of 1991 and money growth does not recover, then (a) it is extremely unlikely that the economy will avoid a significant slowdown, and (b) the slowdown will probably extend beyond 1992 Q1. Of course, the Bank of Japan could drop interest rates quite precipitately once the authorities recognise the severity of the slowdown (say, in 1991 Q4), but it would be preferable from the standpoint of the long term stability of economic growth and inflation to act earlier and more moderately than to have to act later and more drastically.

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Addendum

Since this article was written there have been two developments of importance relevant to the discussion above.

First, Japan's Q1 GNP figures were released on June 19th showing an extraordinary growth of 11.2% annualised in (or 2.7% on a quarter-on-quarter basis) in real terms, and 13.1% annualised (or 3.1% quarter-on-quarter) in nominal terms. These figures were exceptionally high for a variety of technical reasons, but they yield a figure for Marshallian k which is very close to the first asterisk on time path (A) in Chart 4. It therefore looks as though the combination of slow money growth and rapid nominal GNP growth is rapidly restoring Marshallian k or its inverse -- income velocity -- to trend.

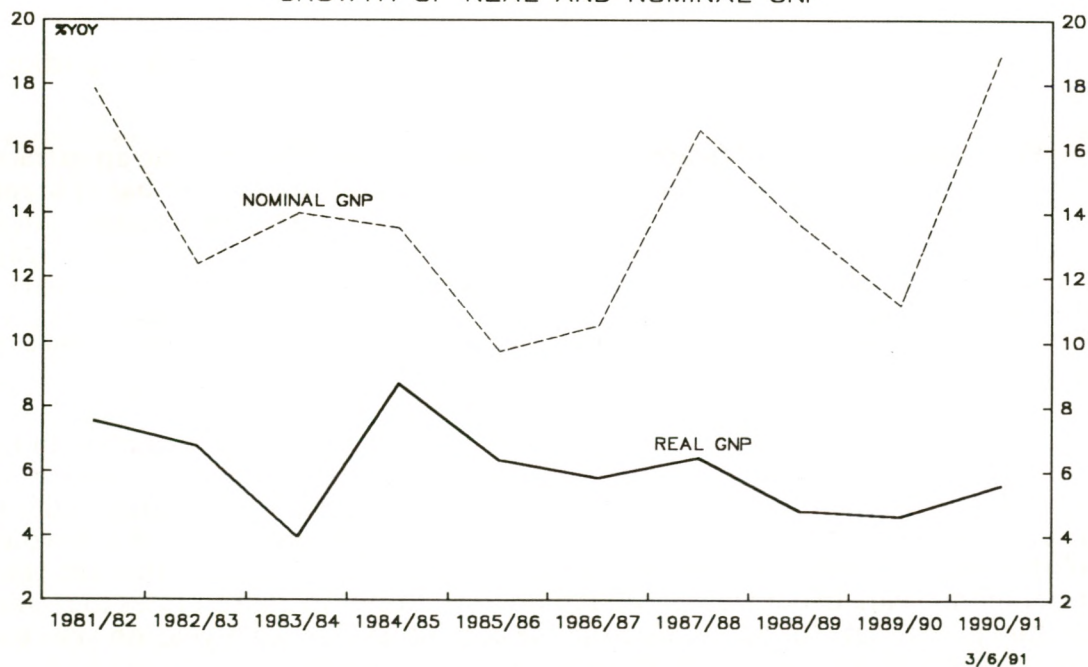
Second, on Monday July 1st, the Bank of Japan announced a reduction in the official discount rate from 6% to 5.5%, signalling some easing of monetary policy. At the same time the interbank unsecured overnight call rate was lowered from 8.0% to 7.6%. Separately, the Bank of Japan had announced a few days earlier that it would abolish Window Guidance (controls on the growth of bank lending) from the third quarter of this year. In our view, it will require several cuts in interest rates to restore monetary growth rate for M2 + CDs from the current level of 3.6% year-on-year to a more appropriate long term non-inflationary growth rate of 8% per year. In broad terms, therefore, these recent developments vindicate the arguments presented in the accompanying article.

PAKISTAN

EMBARKING ON THE ROAD OF ECONOMIC REFORM AND DE-REGULATION

The task of realising the immense economic potential of the Indian subcontinent has been continually frustrated and hampered by the introverted, socialist doctrines adopted following independence. However, although these ideas appear to be as entrenched as ever in India, first Sri Lanka and now Pakistan have recognised the failure of socialism and are moving swiftly to embrace free market policies.

PAKISTAN: CHART 1
GROWTH OF REAL AND NOMINAL GNP



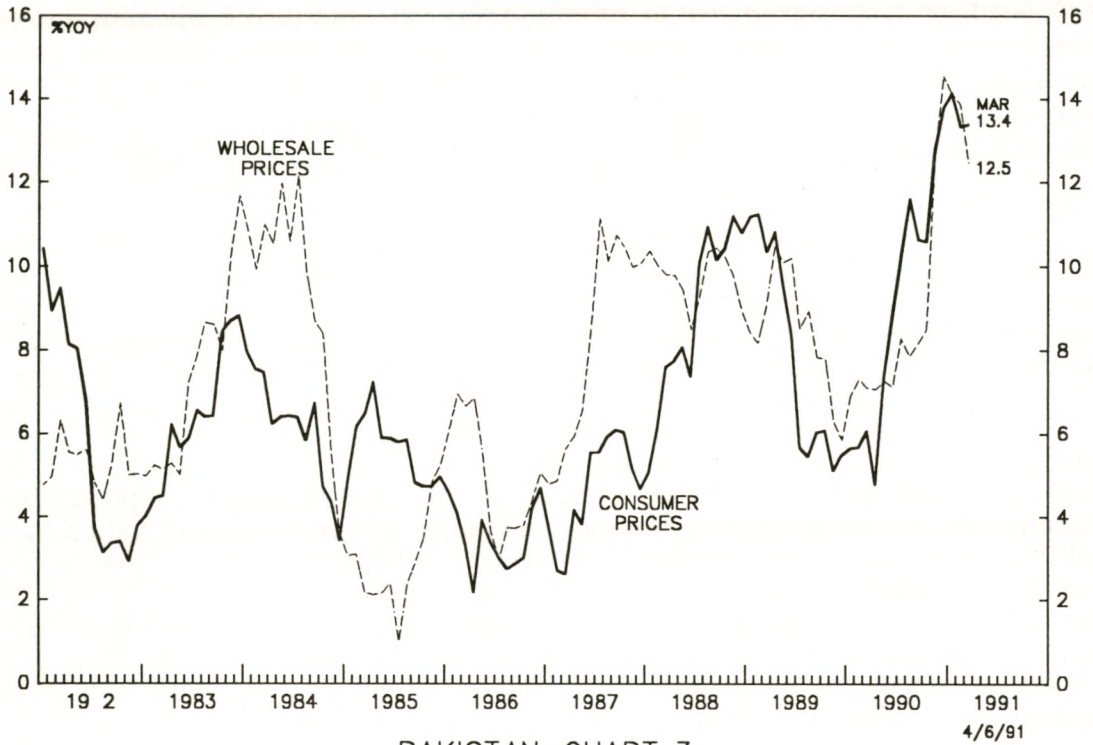
The Pakistan economy has grown in real terms at a respectable 6.1% per annum over the 1980s (Chart 1), but this has not been sufficient to increase the living standards of Pakistan's population of 110 million. A population growth rate of 3% per annum, one of the highest in the world, has meant that per capita income has remained little changed over the decade at under US\$400 a year. Although it had been recognised since the early 1980s that economic policy had been a failure, it was not until the election of Benazir Bhutto's Pakistan People's Party in November 1988 that a few tentative reforms were introduced by finance minister Sartaj Aziz. However, following the dismissal of the Bhutto administration in August 1990 and the subsequent election of Mian Nawaz Sharif in October 1990, the reform programme has been accelerated. Sharif leads the Islamic Democratic Alliance, a coalition dominated by his own Muslim League Party and the quasi-fundamentalist Jamaat-e-Islami. He is an instinctively pro-free market ex-industrialist and has included in his administration a range of like-minded individuals, including Aziz, who has been retained as finance minister.

In his short time in office, Sharif has managed to bypass the reactionary elements in Pakistan's bloated bureaucracy to push through a radical deregulation programme. Reforms have been introduced or promised on trade and tariffs, taxation, interest rates and banking, foreign-exchange and investment. In addition a series of privatisations involving 160 state-owned enterprises has begun. The success of this programme may ultimately depend on Sharif maintaining good relations with the powerful military lobby led by President Ghulam Ishaq Khan and army chief General Aslam Beg. Bhutto, whose father ex-Prime Minister Ali Bhutto was executed on the orders of the late President Zia-al-Haq, fell due to repeated disagreements with the military. Sharif enjoys closer ties but has already clashed with Beg over the decision to send troops to support the US-led coalition during the Gulf war. Nevertheless, assuming differences remain reconcilable, a 5-year mandate and control of both houses of the legislature should ensure that a fair proportion of the programme will be implemented.

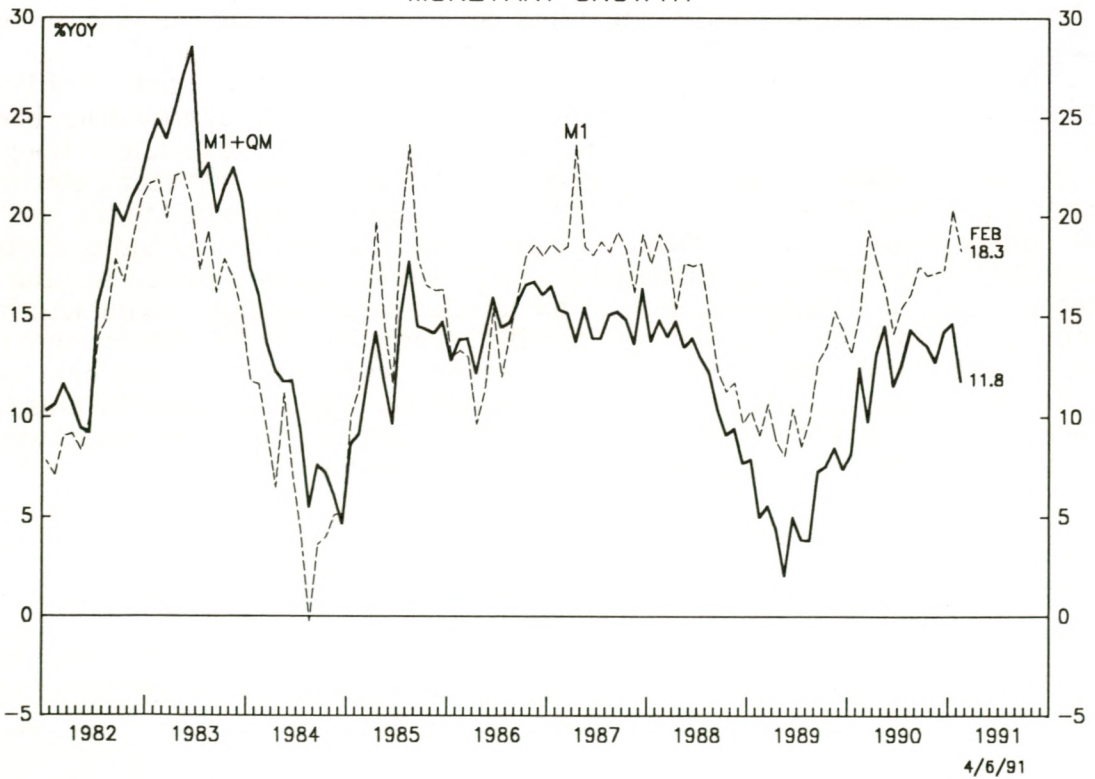
The Pakistan economy has traditionally been dominated by a few influential family controlled corporations including the Prime Minister's own Ittefaq group. The disproportionate influence of these families, who at the peak of their powers controlled over 70% of the banking, finance and industrial sectors, was curtailed by the policy of wholesale nationalisation introduced by Ali Bhutto in 1971. However, this merely succeeded in replacing one inefficient system accountable to no one with another. There is a risk that in trying to reverse this policy, Sharif might restore monopoly powers to these so called "robber barons". Nevertheless, over the past two decades their powers have waned, and anyway the need for a return to a market economy is seen as paramount.

The current state of the economy can be at best described as fragile. Pakistan is suffering from double digit inflation and large deficits in both the government budget and current account. Turning to the domestic economy first, both consumer and wholesale price inflation (Chart 2) have risen sharply since the beginning of 1990 and year-on-year growth rates now comfortably exceed 12%. Money growth has been accelerating towards 20% since early 1989 (Chart 3), in part due to increased budget deficit monetisation and an extra demand for funds to pay for last year's election campaign. However, a number of other factors have also contributed to the rise in inflationary pressures. These include the sharp increase in oil prices and excessive wage and salary growth during a period when infrastructural and capacity constraints have contributed to a deceleration in manufacturing production. Manufacturing production growth has fallen sharply since 1988 averaging only 4% compared to an average of 8% over 1980-87 (Chart 4). Meanwhile, even with unemployment and underemployment at around 15% of the workforce, wages continue to outstrip production growth. For example, the government has managed to increase its wage bill this year by 30% despite laying off 30,000 civil servants.

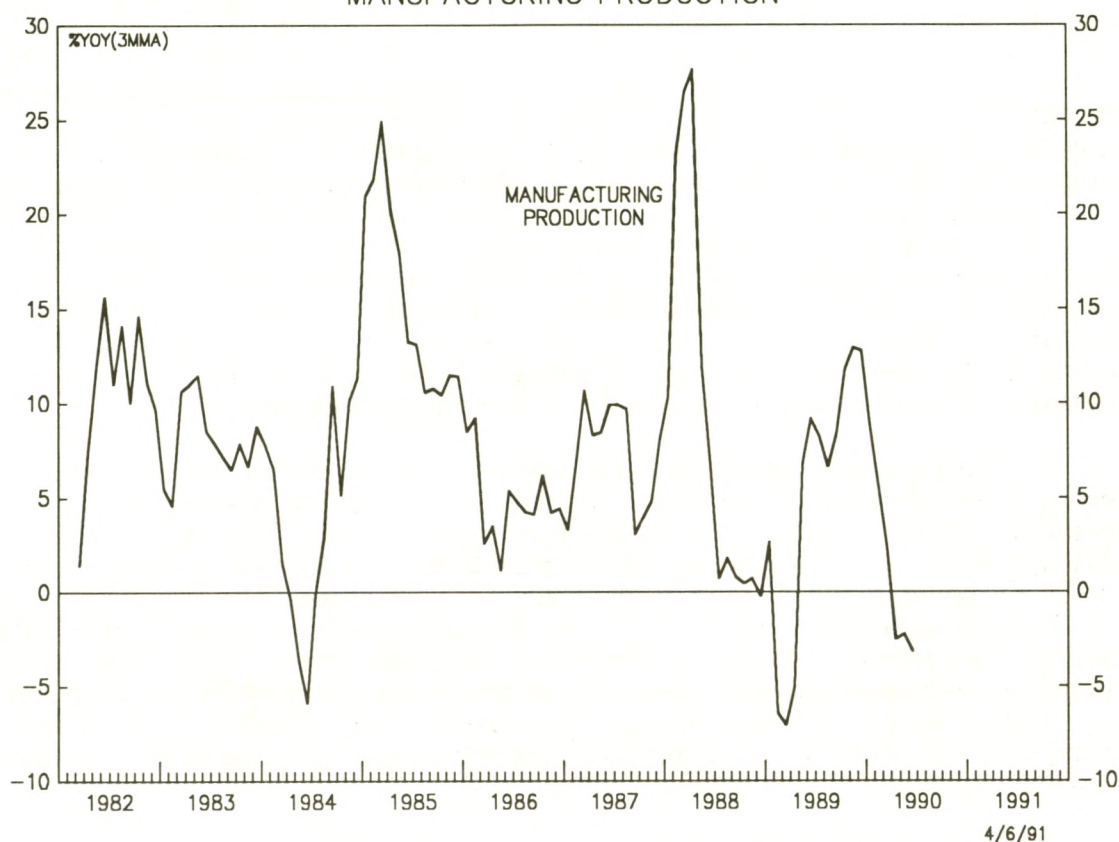
PAKISTAN: CHART 2
INFLATION



PAKISTAN: CHART 3
MONETARY GROWTH



PAKISTAN: CHART 4
MANUFACTURING PRODUCTION



The central bank, the State Bank of Pakistan (SBP), claims that controlling inflation is its number one priority, but like many other central banks it remains a slave to government policy. Nevertheless, money growth appears to have levelled off since mid-1990 and M1 + Quasi Money growth is moving towards the SBP's target of 10% per annum. Combined with the fall back in oil prices, this implies that inflation may have peaked although whether it can fall significantly is debatable. Control of M1, however, remains more difficult as currency still represents around 50% of this aggregate. M1 continues to expand at around 20% per annum due to the sizeable black market demand for cash.

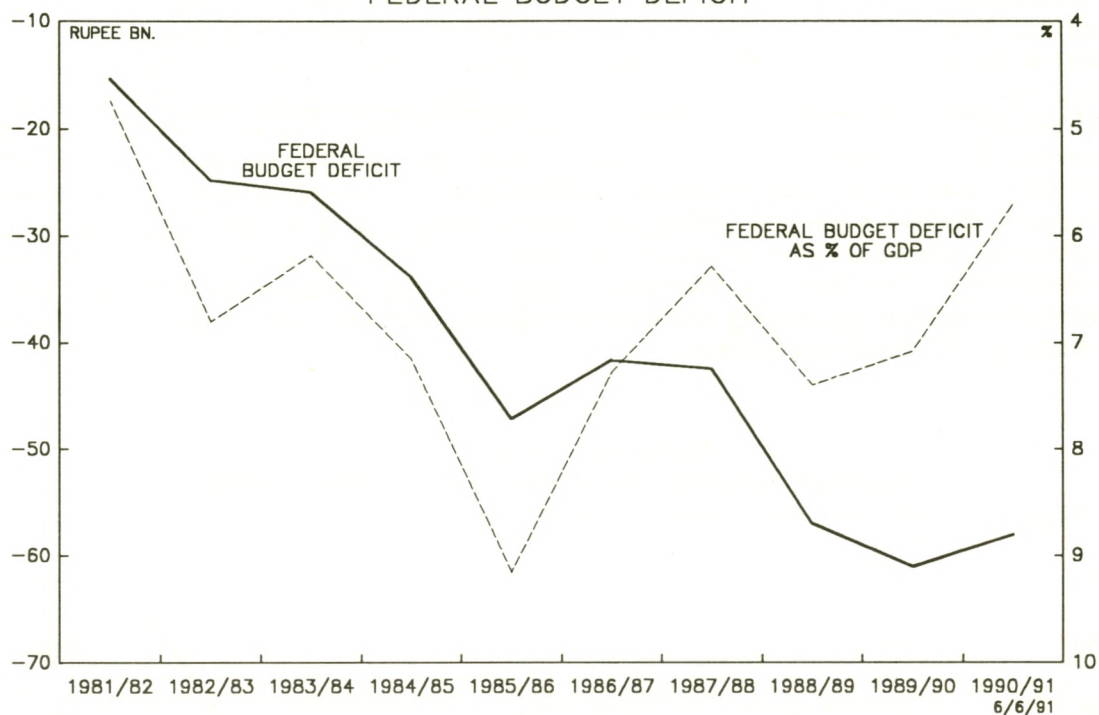
Currently, the only tools of monetary policy available to the SBP are credit ceilings and reserve requirements. Cash reserves have remained unchanged since 1968 at 5% of deposits but banks are additionally required to hold around 30% of their assets in the form of government paper. However, under the new reform programme, the SBP is to move towards open market operations over the next couple of years. Certain interest rates, such as those for overnight money, are being freed and the government is actively developing a long bond market. Bonds with a 10 year maturity have recently been issued and are now trading above par. The intention is to encourage the development of an active secondary market and thus move towards market determined interest rates. Should Pakistan be successful, it would possess the most developed bond market in Asia outside of Japan.

The development of a free bond market should also help the government finance its horrendously large budget deficit (Chart 5). Although the deficit has narrowed from almost 9.5% of GDP in fiscal (year to June)1985/86 to 5.6% GDP at the end of fiscal 1990/91, the improvement has not been enough to satisfy the IMF who suspended loans in 1990. The Sharif reform package includes measures to narrow the deficit but does not attack the root of the problem -- excessive government expenditures. Both defence and debt service absorb around 40% of total expenditures while much of the rest is allocated to subsidies and supporting a sprawling, inefficient bureaucracy. This leaves precious little for sorely needed development and infrastructure expenditure. In the short run it is difficult to see how expenditures can be cut significantly. External debt has risen steadily and now stands at almost US\$20 billion or 40% of GDP (Chart 6), but Pakistan will want to maintain its record of non-default so suspension of payments is improbable. Similarly, the aforementioned military lobby, plus continued domestic unrest in the Sindh and strained relations with India over Kashmir, will prevent sizeable cuts in the defence budget.

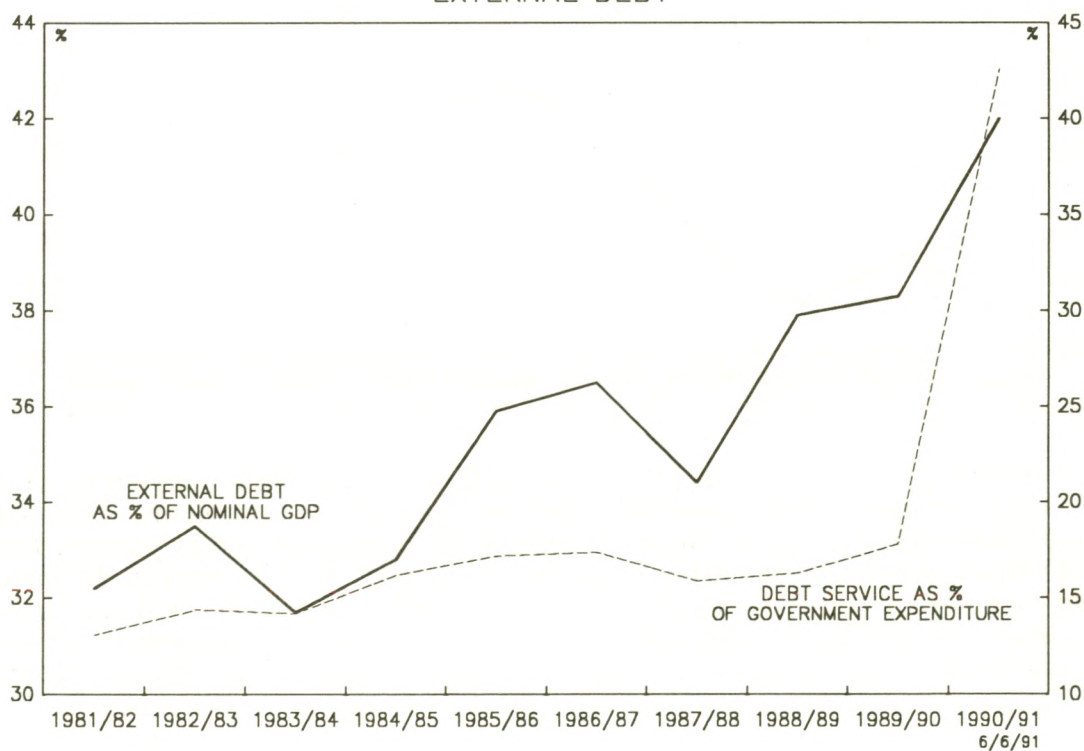
The lack of manoeuvrability to cut expenditures means that the government is relying on privatisation proceeds and an increased tax yield to trim the deficit. The proposed sell-off of 160 state-owned companies over the next year, starting with the part sale of the Muslim Commercial Bank (MCB), should have a double effect. Firstly, the government will reap the proceeds from the disposal of a proportion of its US\$30 billion in public sector assets. The MCB sale is expected to raise around US\$50 million, for example. Secondly, Sharif has estimated that around 90% of the companies to be sold are loss-makers. Many are over-manned by 50% or more, and are plagued by low productivity and high absenteeism. Ridding itself of these enterprises will, therefore, save the government the significant cost of funding these losses.

The government also hopes to raise extra revenues by increasing its meagre tax yield. Income and corporation taxes currently raise only US\$750 million per annum or around 15% of total tax receipts, while customs and duties provide over 60%. Among reforms already proposed or implemented is a cut in the maximum rate of income tax from 55% to 35%, and a promise to cut tariffs to a maximum of 50% by 1994 from 90-95% now. In addition, the discretionary powers of tax collectors are to be vastly curtailed and new direct collection methods are to be introduced. It is hoped that by lowering penally high tax rates and reducing the opportunities for evasion and corruption, an extra US\$1 billion can be raised this fiscal year alone. Unfortunately, taxes on an agricultural sector that represents over 25% of GDP are still no nearer. Farmers continue to receive cheap, subsidised loans and pay no taxes. For example, a range of subsidies to growers of Pakistan's major export, cotton, allow them to produce at under 60% of the world price. These subsidies have encouraged farmers to triple production to 9 million bales per annum over the last 5 years, making Pakistan the second largest producer in the world after India. However, not only are subsidies a continuous drain on government resources, but with a guaranteed 40% margin there is little incentive to develop the production process beyond the yarn spinning stage. Pakistan is therefore, passing up the opportunity to fully develop a domestic textiles industry.

PAKISTAN: CHART 5
FEDERAL BUDGET DEFICIT

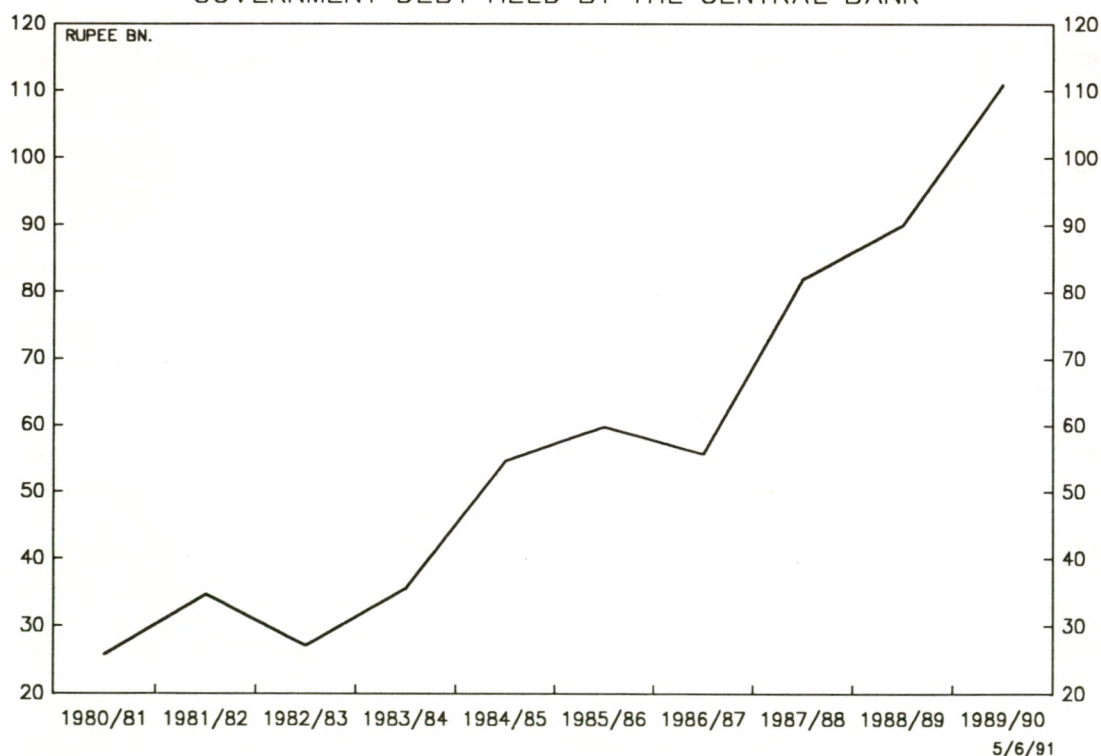


PAKISTAN: CHART 6
EXTERNAL DEBT



Financing the deficit this year may be made easier by a windfall of foreign aid and loans as a result of Pakistan's decision to support the "right" side in the recent Gulf conflict. In recent years, the deficit has been part financed by expensive short term borrowings at up to LIBOR + 3%, and by increased deficit monetisation (Chart 7) which has contributed to the increased rate of growth of money and inflation. It is estimated that the Gulf war cost Pakistan US\$700 million in lost remittances, increased oil prices and the loss of a Kuwaiti market that was the destination of 10% of exports. However, although loans from the US are still suspended due to Pakistan's refusal to clarify its nuclear policy, aid has been pledged from the UAE and Saudi Arabia and since January, the latter has been providing 50,000 barrels of oil per day -- about 65% of the daily requirement -- free of charge. In addition, other countries and institutions are discussing new loans or existing loan write-offs, while negotiations to restore IMF funding continue.

PAKISTAN: CHART 7
GOVERNMENT DEBT HELD BY THE CENTRAL BANK

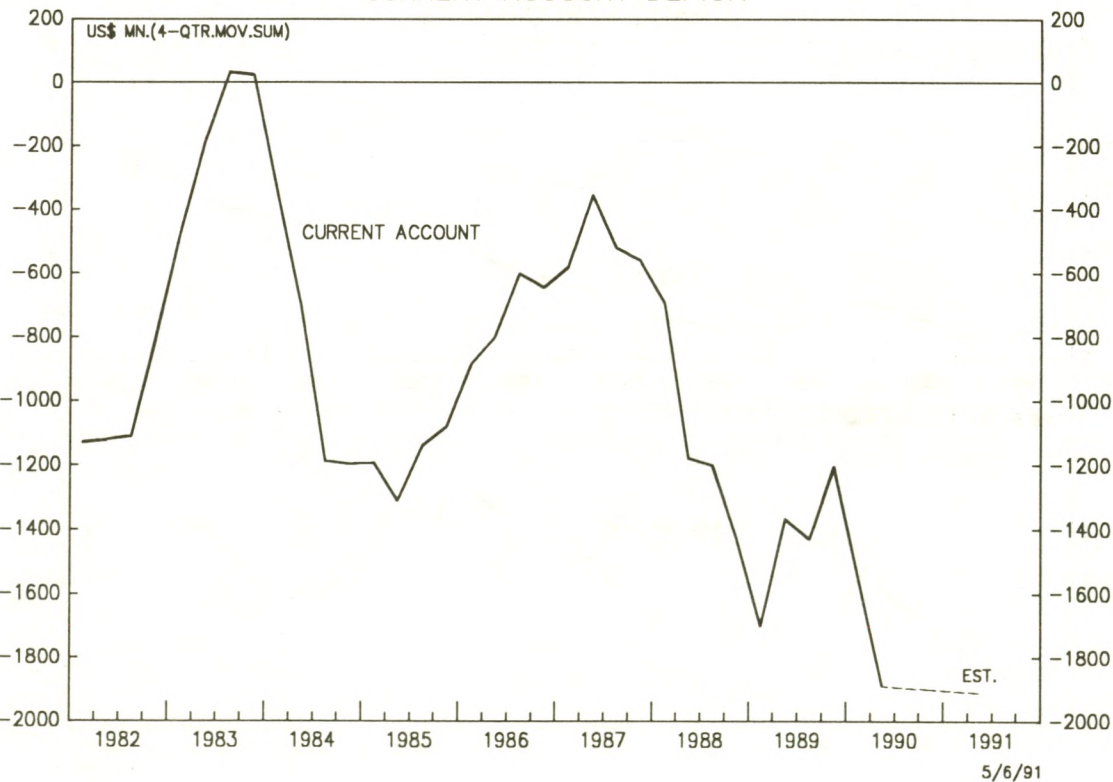


The resumption in the supply of external funding, plus the continued supply of free oil, have significantly eased Pakistan's foreign exchange problems. Following Iraq's invasion of Kuwait in August 1990, foreign exchange reserves plunged from US\$500 million to only US\$150 million or 1 week's import cover in October. However, they have since rebounded to pre-August levels and it is hoped they will rise further due to the lifting of both foreign exchange controls and rules governing the disclosure of sources of funds. The rupee has recently been made freely convertible and tax-free foreign currency accounts can now be opened by foreigners and Pakistanis alike.

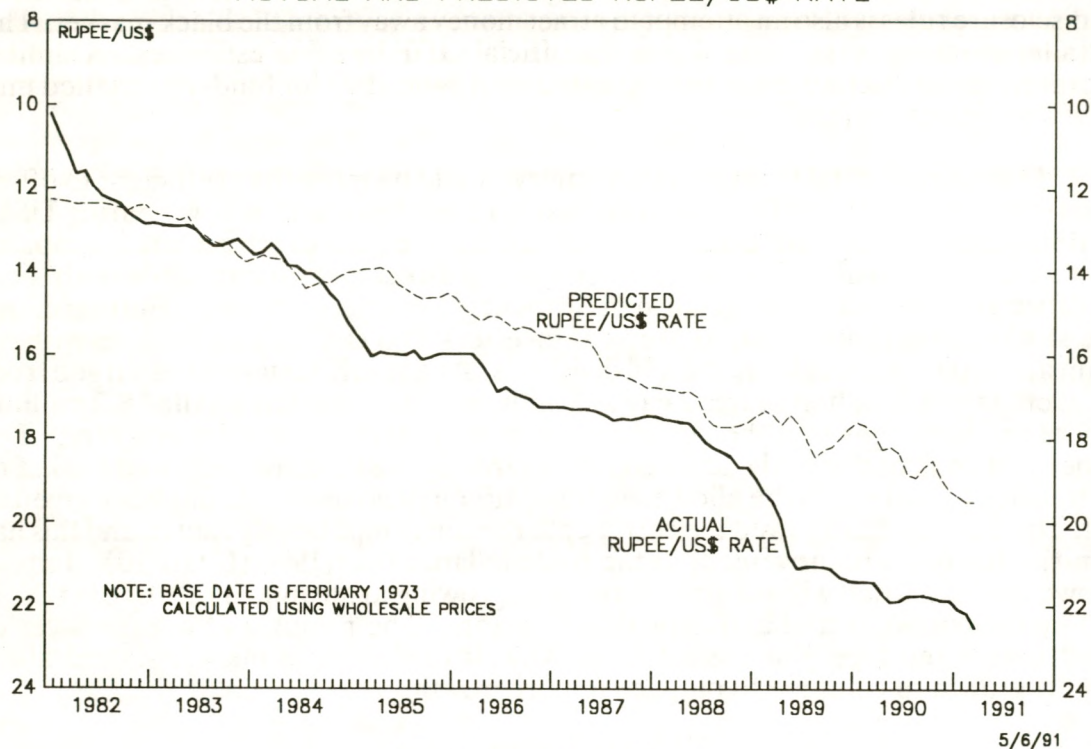
These accounts pay premium interest rates and are primarily designed to attract back some of the estimated US\$17 billion held by Pakistanis abroad. In addition, the lifting of disclosure rules is also an attempt to attract money away from the black market. The parallel economy is the same size as the official GDP by some estimates. A similar moratorium on disclosure has been granted until June 1992 for funds channelled into new investment projects.

Increasing capital flows into the country should be more than sufficient to offset a current account deficit that has worsened in recent years and is now nearing US\$2 billion (Chart 8). The authorities are doing all that they can to attract foreign capital; there are now virtually no restrictions on foreign direct investment, while both local and foreign firms can raise foreign loans without government approval. Furthermore, the stockmarket is now open to overseas investors who can buy local shares without limit and repatriate freely capital and dividends. As a result, turnover has surged from an average of 1.5 million shares a day to 3 million, and on one day totalled 8.2 million. There are also signs that the current account may start to improve this year. The rupee, which is periodically adjusted downwards against a trade weighted basket of currencies (Chart 9) is to be allowed to float, although no timetable has been given as yet. Devaluation has allowed the currency to remain competitively valued and this has contributed to an improvement in the trade balance over 1990 (Chart 10). Import growth has stabilised while exports have been growing at an annual rate of over 20%, led by the cotton, textile and agricultural sectors. The removal of a large layer of government red tape plus the return of Kuwait to the world market should allow export growth to continue to outpace import growth.

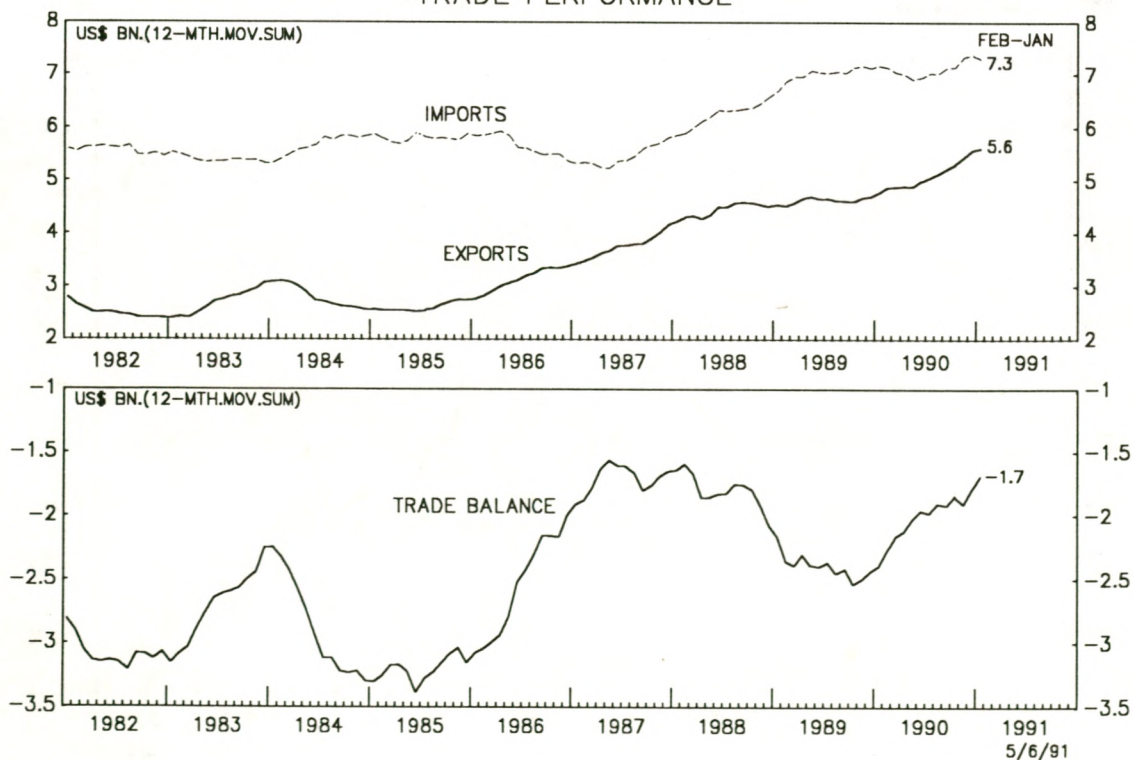
PAKISTAN: CHART 8
CURRENT ACCOUNT DEFICIT



PAKISTAN: CHART 9
ACTUAL AND PREDICTED RUPEE/US\$ RATE



PAKISTAN: CHART 10
TRADE PERFORMANCE



SUMMARY AND CONCLUSION: The wide ranging reform and deregulation package introduced in Pakistan in recent months should help to stimulate growth in almost every sector of the economy. Although a number of problem areas have for the moment been left untouched -- notably taxes and subsidies on agriculture and excess military spending -- the move towards economically "correct" policies is encouraging and should be rewarded by a rebound in economic growth and improvements in the balance of payments and the government budget.

Pakistan, unlike India, has been offered the benefits of a strong and stable government, and has seized the opportunity to turn its back on subcontinent socialism. It is also encouraging that even the introduction of Shariah law in response to the demands of an increasingly "Islamicised" population has had no noticeable effect on policy. The danger remains that the military and/or the bureaucracy will attempt to thwart the government's programme, but given that such difficulties can be overcome, the outlook for the Pakistani population in terms of economic progress is as bright as at any time since partition in 1947.

S. KOREA

THE STALLING ECONOMY AND FINANCIAL DEREGULATION

Introduction

The performance of the Korean economy during the 1980s was characterised by high rates of economic growth fuelled by a dynamic exports sector. The Korean financial and banking markets, however, remained highly regulated and controlled. During 1989-91 there have been signs of structural changes in the Korean economy. This article analyses these structural changes and outlines the role of the controlled financial markets in causing some of these changes to happen in the first place.

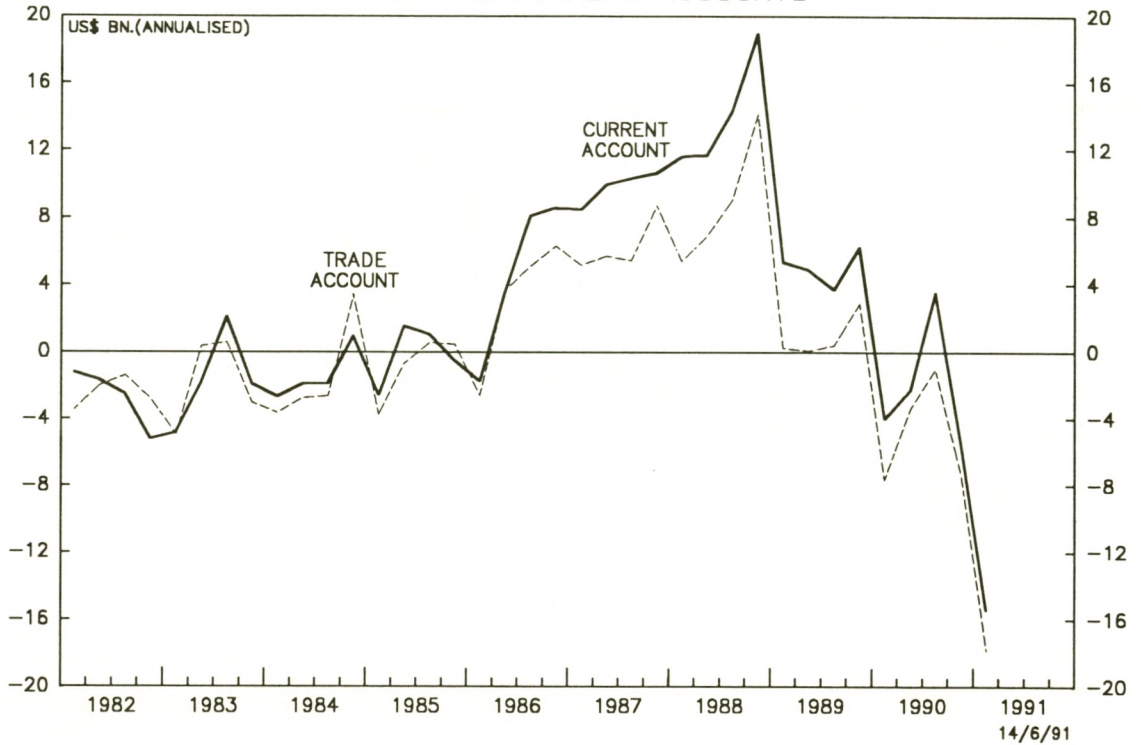
The large surplus in the current account which Korea had accumulated since 1986 Q3, turned during the first quarter of 1990 into a seemingly ever-rising deficit (Chart 1). The current account deficit for the first quarter of 1991 stood at US\$4.81 bn, an increase of nearly 300% over the same quarter in the previous year. The official predictions of a US\$2 bn deficit for the whole of 1991 are unlikely to materialise unless exports growth increases significantly. Korea is now running trade deficits with all three of its major trading partners: US, Japan and the EC.

Some of the reasons for this turnaround in the performance of the external sector have been explored in a previous AMM article (Vol. 14 No. 5, Sept.-Oct. 1990). Chart 2 shows that the won appreciated continuously in real terms (Real Effective Exchange Rate) from the start of 1988 to 1989 Q3. The lagged effects of this decline on the external competitiveness of Korea plus the slowdown in the US economy continue to influence exports. As Chart 3 shows, imports have been growing faster than exports since 1989 Q1 and export growth is now at nearly half the rate it was during its heydays in 1987-88.

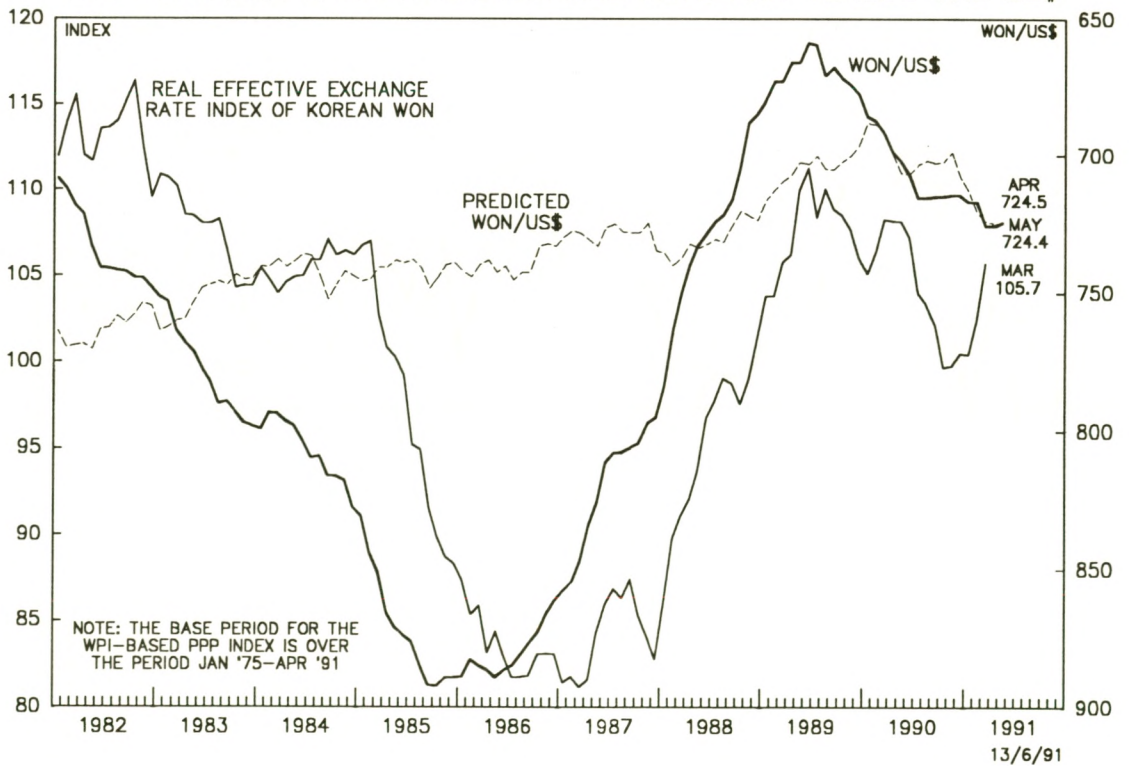
The Korean economy, however, continues to grow at an enviable pace, with real GNP rising by 8.9% during the first quarter of 1991 (Chart 4). The economy may end up growing during 1991 at rates well in excess of the original official forecast of 7%. Given the slowdown in the growth of exports it is not surprising that domestic demand now plays a key role in maintaining high levels of national output (Chart 4). Construction in particular has been making an important contribution. The service and construction sectors together added 40% to the growth of output in 1991Q1 compared to the 30% contributed by manufacturing. During the same period construction output grew by 23% yoy compared to the 7.5% growth of manufacturing. For a country where, on average, exports account for nearly 40% of GDP (1985-1990), domestic demand will need to continue to rise fast in order to maintain these high growth rates.

The monetary conditions, however, indicate that there is a progressively tighter liquidity squeeze on. As Chart 5 shows M2 was given a sharp boost in December 1989 as part of an attempt to support the equity market and to channel funds to the exports, construction and plant investment related sectors. This ill-conceived and ill-advised policy measure caused money growth to accelerate until March 1990, but since then the authorities have reverted to their aim of maintaining M2 growth during 1991 at less than 20% and preferably within 17-19%. Given current rates of inflation at around 9% (Chart 6) money stock is now growing in real terms at approximately the same rate as that of the economy. As Chart 7 indicates the growth of loans has also fallen sharply since the beginning of 1990. As will be shown later on, interest rates for most banking

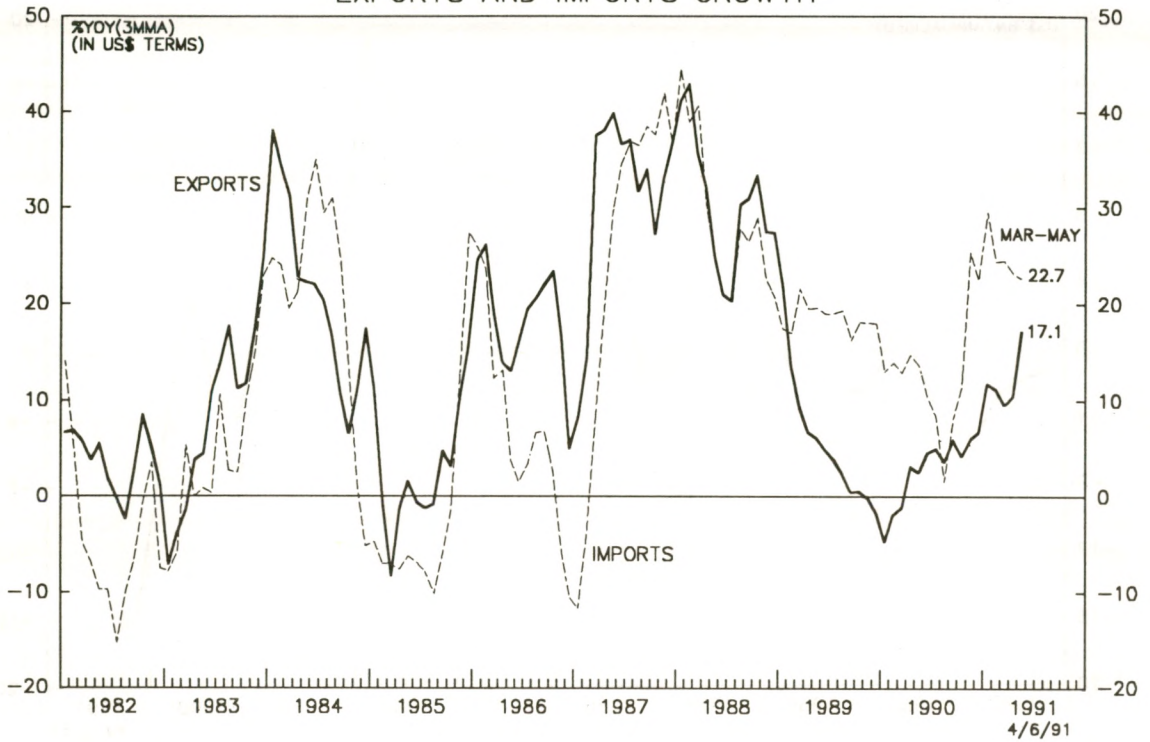
S.KOREA: CHART 1
TRADE AND CURRENT ACCOUNTS



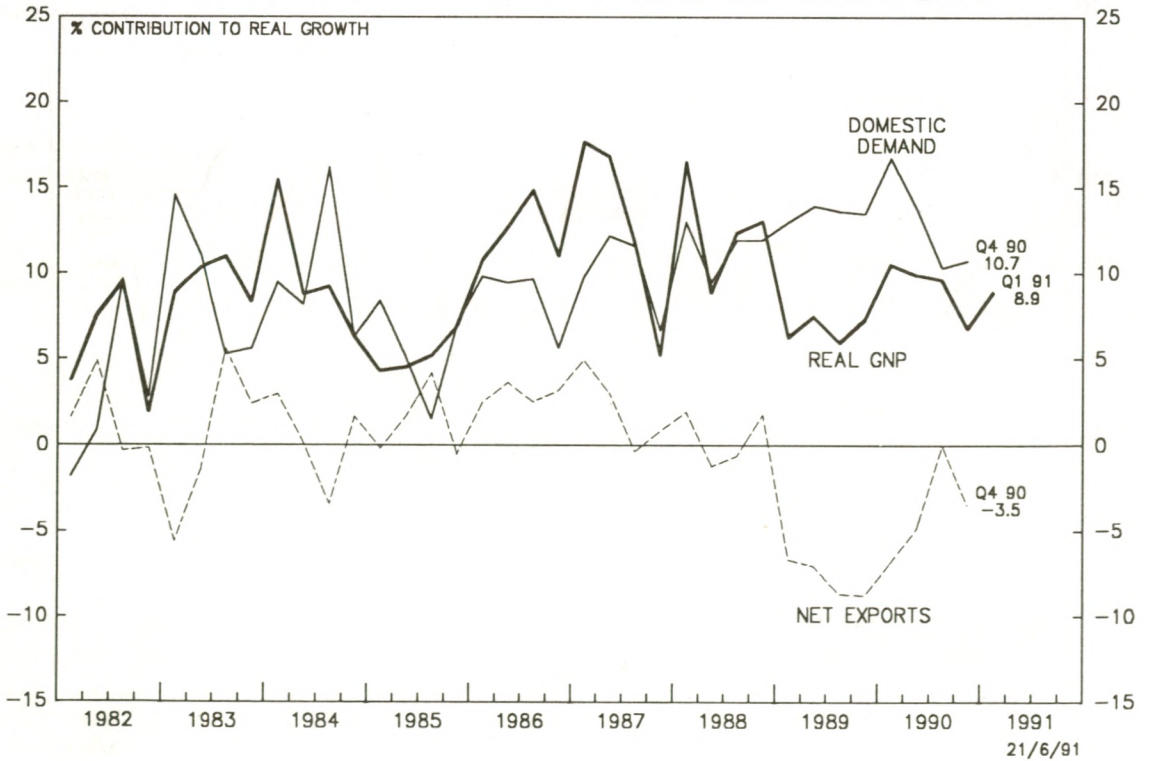
S.KOREA: CHART 2
THE WON REAL EFFECTIVE EXCHANGE RATE AND VERSUS THE US\$



S.KOREA: CHART 3
EXPORTS AND IMPORTS GROWTH



S.KOREA: CHART 4
CONTRIBUTION TO GROWTH OF REAL GNP COMPONENTS



and financial activities in Korea are heavily influenced by the authorities and hence are not market clearing. There is also extensive and pervasive direct control by the government over the allocation of loans by banks. Further evidence for the credit squeeze has to be found in the movements of the few interest rates which are market determined and in the government rules concerning the sectoral allocation of credit to sectors by banks. So, for example, corporate bond yields, Monetary Stabilisation Bonds (a type of freely traded government bond) as well as interbank rates have all risen or stayed at comparatively high levels during 1990 and 1991 (Chart 8). Aside from the boost in money stock in December 1989, the Korean authorities have pursued since then a tight monetary policy. Any impact on consumer prices of that temporary boost in money stock is likely to be short lived given the apparent determination of the authorities to keep money growth down, as evidenced by the rising free interest rates.

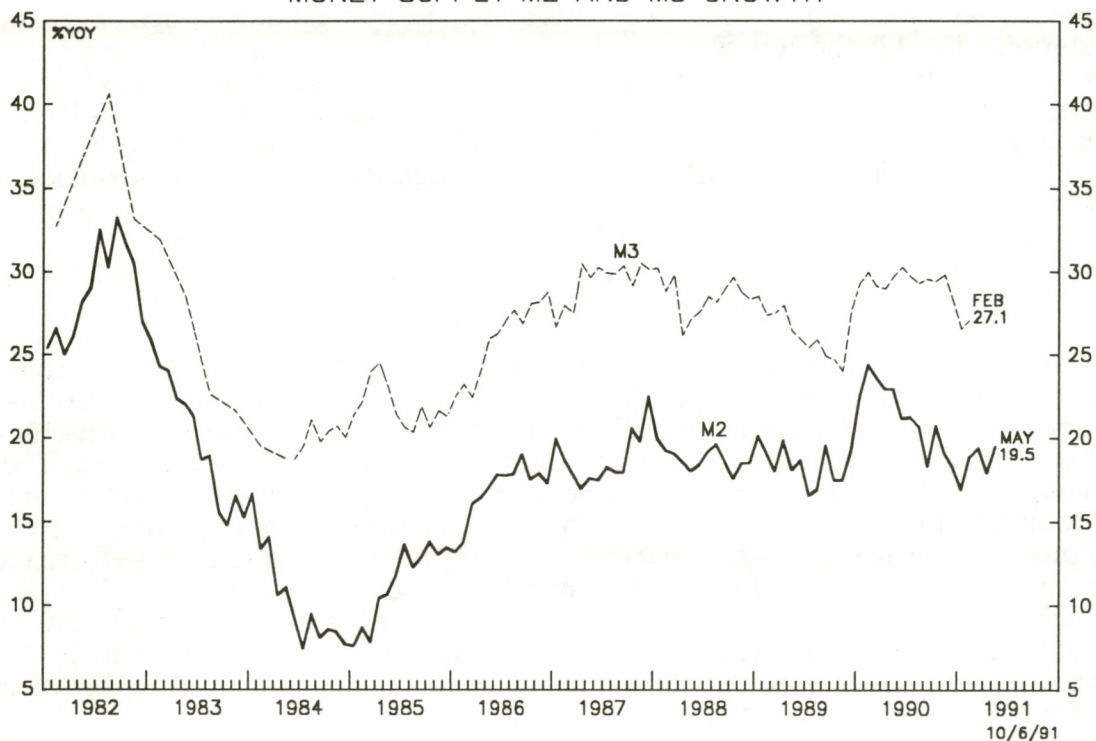
At this juncture Korea has all the characteristics of an economy in the throes of significant structural changes and readjustments. The rapid switch from a surplus to a deficit in the current account, coupled with continued high GNP growth rates based on domestic rather than external sources of demand, are indicative of changes. These changes are affecting not only the competitiveness, productivity and efficiency of the external sector, but also the savings and investment relationships and hence the shares of profits and wages in the national income. These dynamic conditions in Korea are coupled with a rigid, regulated and practically closed banking and financial system which is causing distortions of its own. Domestic and international pressures will eventually cause the Korean economy and financial system to open up and to drop the excessive regulatory superstructure and framework. This will lead to significant readjustments in interest rates and hence to asset prices.

Structural Changes in the Korean Economy

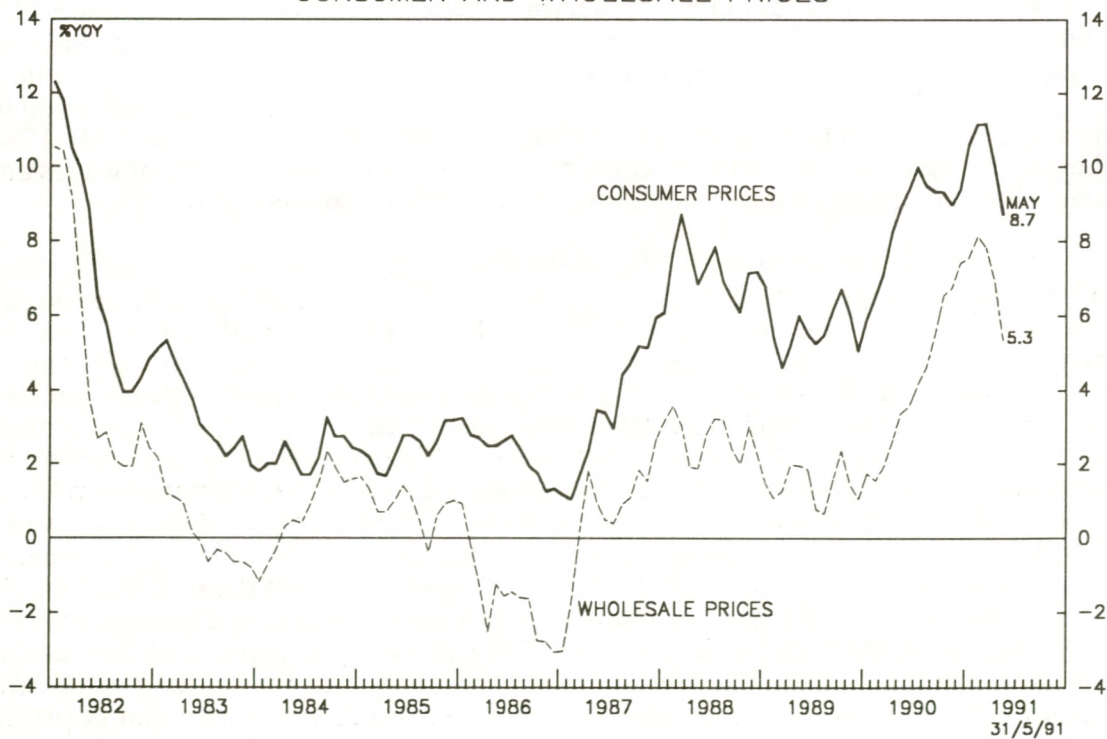
The share of the manufacturing sector in GDP has hardly changed since 1985 when it stood at 31.4% compared to an estimated 33.7% in 1990. Equally the proportion of the labour force employed in manufacturing has stayed almost stationary at nearly 27% during this period. Not surprisingly the service sector expanded its share of employment from 48.4% to 53.0% of the active labour force over 1987-1990. There is, however, a different story concerning changes in the behaviour of wages and in the share of labour in the national income of the Korean economy.

As Chart 9 shows between 1982 and 1986 monthly earnings in manufacturing and mining first experienced declining growth (1982-1983) and then grew at roughly constant rates until the end of 1987 when political activism and waves of strikes changed the trend. The wage growth explosion of 1988-89 was partially due to democratisation of the political scene in Korea with the free election of president Roh Tae Woo in December 1987. There was also a justifiable sense of grievance amongst Korean workers. Chart 10 indicates that between 1982 and 1985 labour productivity in the manufacturing sector increased by nearly 25%, whilst the information in Chart 9 shows that earnings averaged approximately 12% yoy growth during the same period. Despite the very sharp increases in earnings during 1988-89 labour productivity continued to rise, increasing by over 30% between 1988 and the end of 1990. As a simple comparison of Chart 6 (inflation) and Chart 9 (nominal earnings growth) shows, between the middle of 1987 and 1989 there were rapid and substantial increases in real incomes. It is not, therefore, surprising that the share of wages and salaries in the GNP rose rapidly since 1987 and now stands well above that of profits (Chart 11).

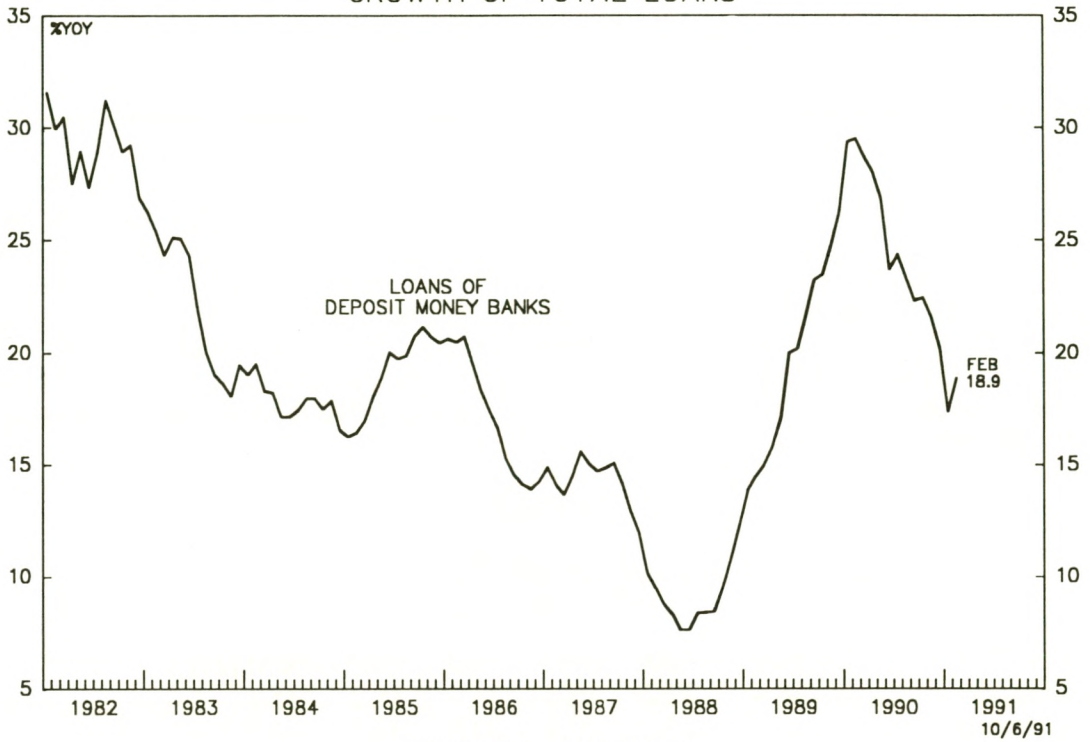
S.KOREA: CHART 5
MONEY SUPPLY M2 AND M3 GROWTH



S.KOREA: CHART 6
CONSUMER AND WHOLESALE PRICES



S.KOREA: CHART 7
GROWTH OF TOTAL LOANS



S.KOREA: CHART 8
INTEREST RATES

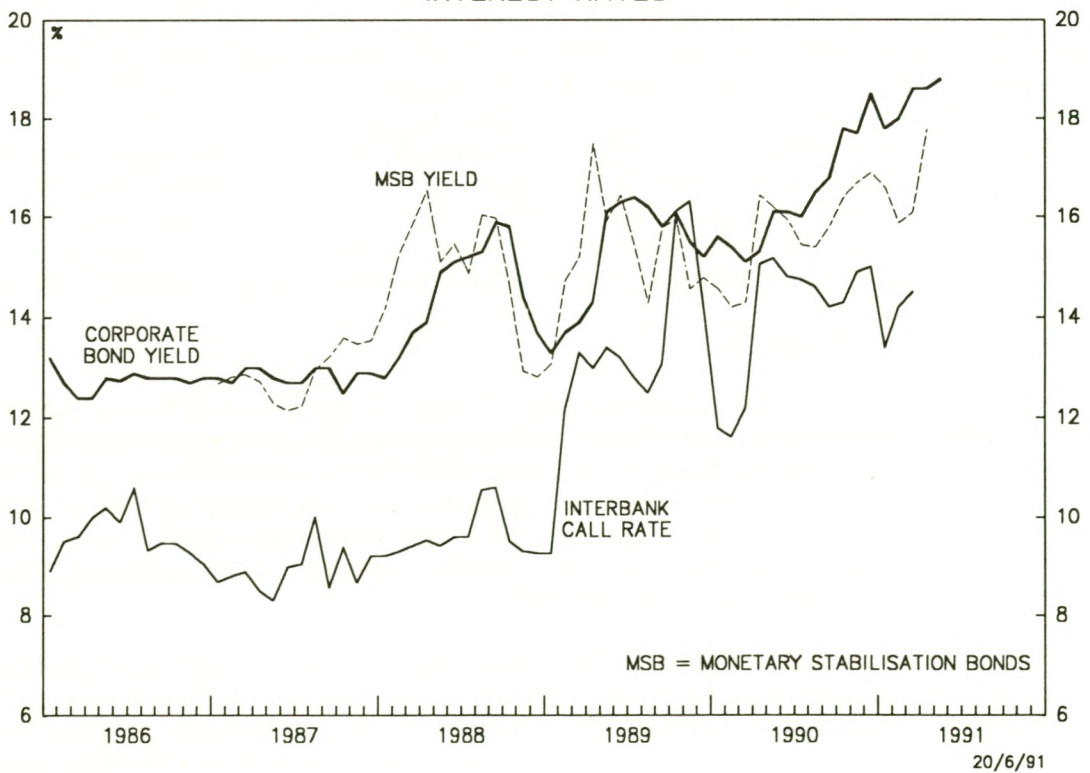


Table 1 shows that gross savings as a percentage of GDP started to decline since 1988 and in 1990 dropped below the equivalent proportion of gross investment. The behaviour of these important macroeconomic aggregates also match perfectly that of the current account surplus/deficit as shown in Chart 1. Basic national income accounting relations indicate that

$$(S - I) = (G - T) + (X - M)$$

where S = savings, I = investment, G = government expenditure, T = taxes, X, M = exports and imports of goods and services. Since 1989 the excess of savings over investment (S-I) narrowed and finally in 1990 became negative. The Korean government maintains a broadly balanced budget, or more accurately, it achieves a small surplus which has declined as proportion of the national income since 1988. The difference (G-T), the budget deficit/surplus, is therefore effectively zero. It now follows that as (S-I) declined, (X-M) had to fall, i.e. the current account surplus shrank, as it did from 1989 onwards.

Table 1
Gross Savings and Domestic Capital Formation as
Percentage of GDP

	1985	1986	1987	1988	1989	1990 (est.)
Savings	28.4	32.2	36.0	38.0	35.2	35.1
Investment	29.2	28.3	29.4	30.6	33.5	36.9

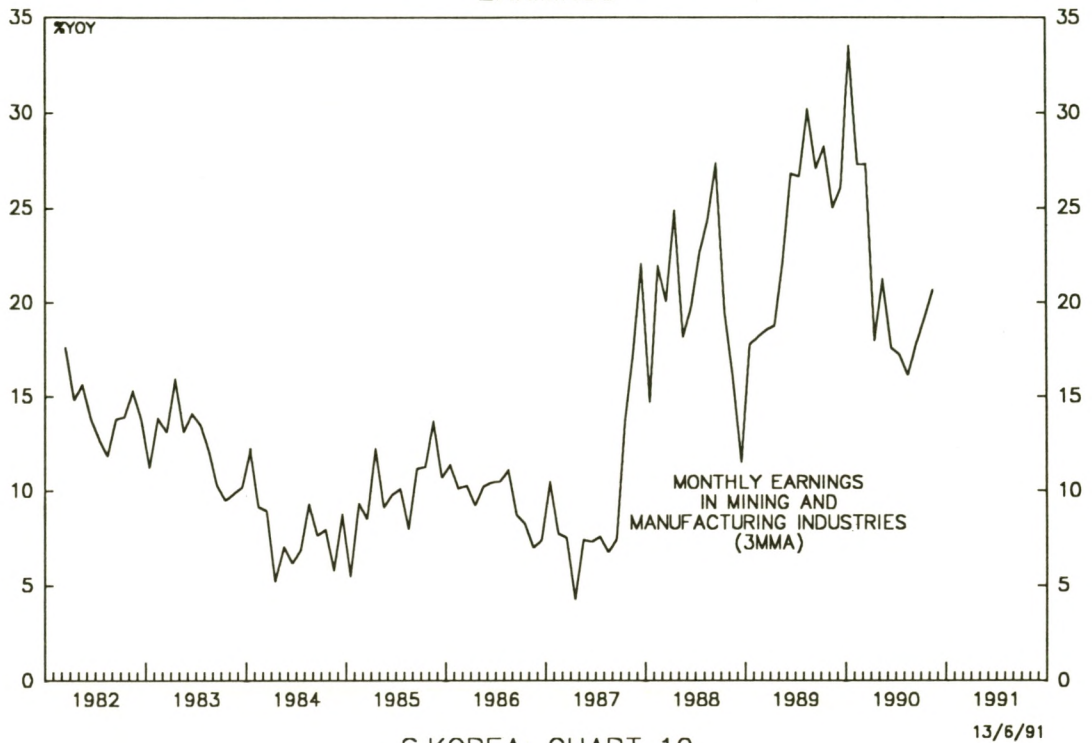
The falling average saving rate reflects, to some extent, an adjustment in the spending patterns of the household sector following the rise in real incomes after the high nominal earnings increases of 1988-89. It also undoubtedly reflects the constraints being placed by a rigid and controlled financial system on the portfolio choices of an increasingly affluent, urban and sophisticated population. There is also the added impact of an official housing policy which led, through increasingly complex regulations, to price distortions which made the acquisition of a house an impossibility for a large section of urban population. These developments discouraged primary saving activities such as those related to mortgages, and in the absence of other opportunities offering real returns, people in Korea chose to spend rather than save.

The Distortions of Regulation

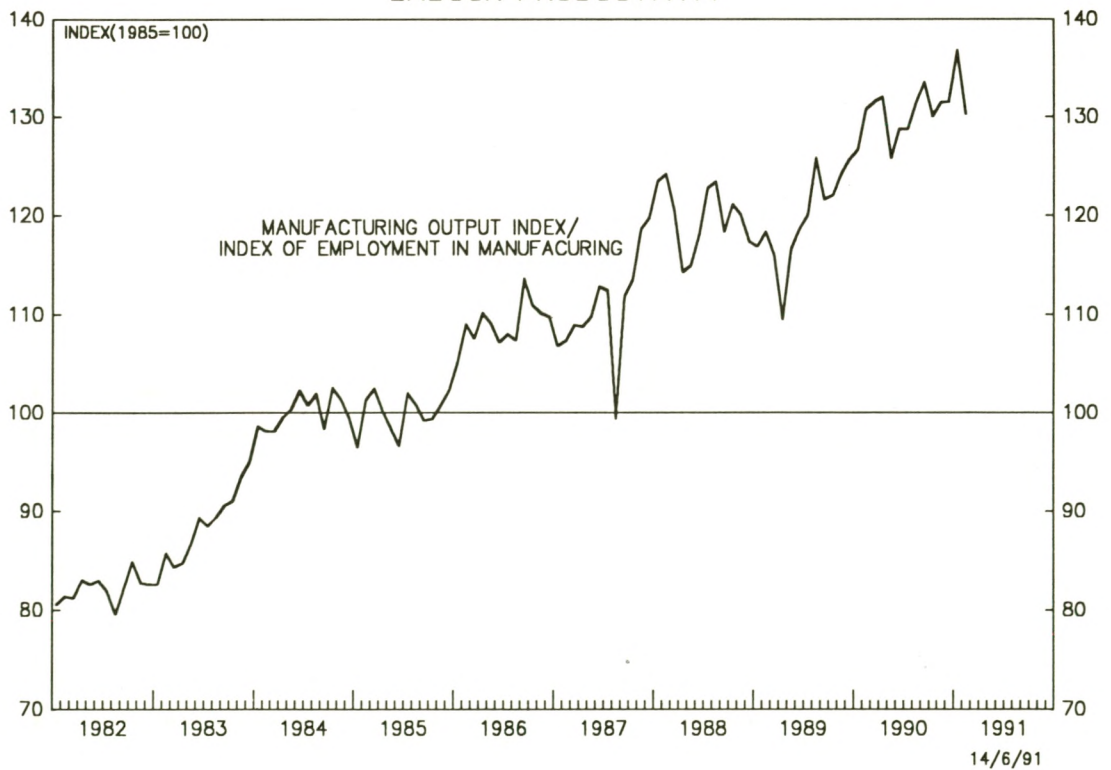
Chart 12 shows at a glance a key aspect of financial regulation in Korea: interest rates on bank deposits which are officially fixed and virtually unchanged over years at a time, coupled with a central bank discount rate which also changed slowly if at all (viz 1982-1986 H.1). Table 2 summarises the tentative and reluctant steps which have been taken by the Korean authorities in liberalising the banking system. As recently as June 1991 the authorities were hinting at further steps in the area of interest rate deregulation only to postpone them for 1992.

Direct foreign participation in the equity market has already been partially achieved since foreigners do hold and are exchanging convertible bonds for equity. The Korean won is on a managed float basis with the authorities progressively widening the bands of acceptable fluctuations and hence relatively limiting their inter-

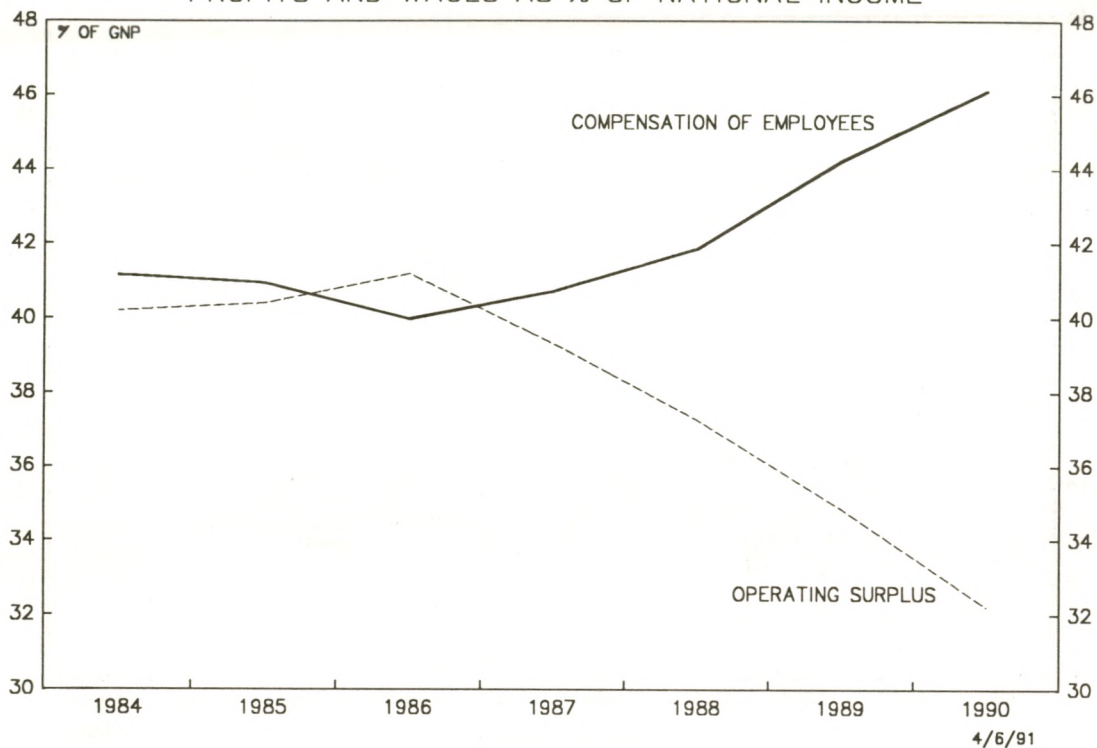
S.KOREA: CHART 9
EARNINGS



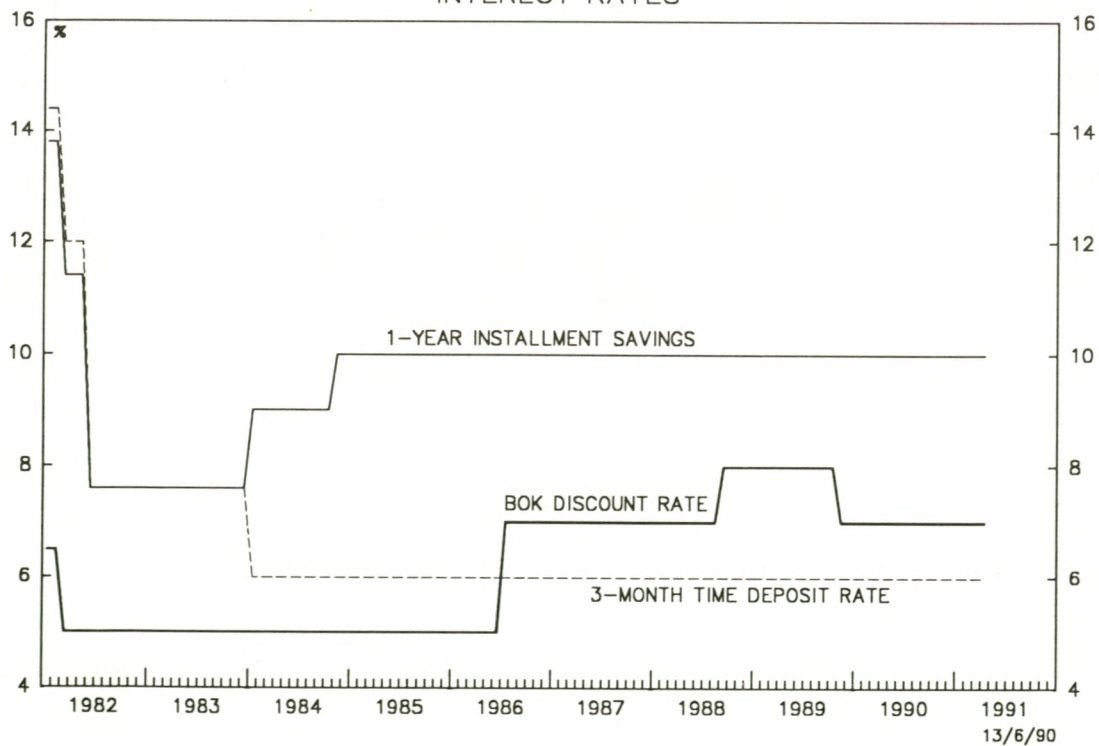
S.KOREA: CHART 10
LABOUR PRODUCTIVITY



S.KOREA: CHART 11
PROFITS AND WAGES AS % OF NATIONAL INCOME



S.KOREA: CHART 12
INTEREST RATES



vention.

Table 2

Banking Liberalisation in Korea

1981-82	4 banks denationalised.
1982-84	Introduction of, and trading in various instruments such CDs, Repos, Money Market Funds etc.
1984	Banks permitted limited variations in the officially set lending rates.
1988	Most bank and nonbank lending rates liberalised, but short to medium term deposit rates (1 month to 2 years) still controlled, as are savings rates.
1989	Interbank call market unified with that of nonbank intermediaries.

Perhaps the major setback in this limited progress of financial liberalisation was the 1988 interest rates fiasco. Although, on paper, banks were supposed to charge market-determined interest rates on loans, overdrafts and discounts, it has been commonly known and acknowledged that a combination of inertia, behind-the-scenes government pressure and unwillingness of the banks themselves to change their practices, led to no real change.

As another indication of the extent of the potential distortions in asset prices which the direct control of interest on bank deposits has produced, the following Table 3 shows the current interest rates payable on all classes of deposits with the main Korean banks (Deposit Money Banks). The levels of these interest rates must be compared with Korea's accelerating inflation, particularly during 1990-1991 Q2, when these rates either declined in real terms or became progressively negative.

Table 3

Interest Rates on Bank Deposits in Korea

Time Deposits

1 - 3 months	4% since 1984
3 -12 months	10% since 1984
1 - 2 years	10% since end of 1984
2 years or more	Market determined since 5/12/88

Savings

5% since 5/12/1988

Preferential Savings

From less than 3 months and to 6 months and over, 5% to 11% since 5/12/1988

Installment Savings

1 - 3 years	10% (with some exceptions) since end of 1984
-------------	--

Similar fixed interest rates are offered by nonbank financial intermediaries such as Mutual Savings Companies, Credit Unions, Postal Savings and the ubiquitous Investment and Finance Companies. The latter provided some of the much-needed flexibility in Korea's financial system to the extent that they operated outside direct government control. In any case these institutions could, and did, charge market rates on their loans since the partially aborted interest rate deregulation in 1988. Recently, however, the authorities have been encouraging Investment and Finance Companies to choose between their banking or equity-oriented activities, and a number of them are in the process of becoming fully-fledged banks.

A further retrograde step in the process of financial deregulation was taken in April 1991 when under the government's orders the 30 major Korean conglomerates (chaebols) were asked to nominate three of their main subsidiaries as core sectors of their operations. These three subsidiaries are meant to be the vanguard of an attempt to make Korean firms specialise in some areas only and thus foster the growth of "world class enterprises". The carrot in this specialisation drive is that these subsidiaries will be exempt from credit controls normally imposed on chaebols which are expected to self-finance the expansion of their activities. The remaining sectors or subsidiaries of these conglomerates will be required to reduce their bank loans and to freeze the rates of their borrowing at current levels. Furthermore, any subsidiary of these companies where the parent company holds not more than 8% of the equity will be automatically exempted from any credit controls.

The outcome of this arbitrary policy action was predictable. The major conglomerates chose as their core subsidiaries those which were most heavily geared or likely to require in the near future large injections of cash. Of the 85 core firms selected towards the end of May, 54 which were listed in the Korean Stock Exchange had a debt to equity ratio of 304%, well in excess of the average 261% for most large manufacturing firms. Nine of these companies had debt ratios in excess of 400% and fifteen had ratios of 300%-400%. These selected sectors are not necessarily the more competitive or productive in the Korean economy. All of the 30 chaebols with petrochemical subsidiaries chose them as their core operations. In the post-Gulf War period and amid the uncertainty over the future movements of oil prices it is by no means obvious why Korea should concentrate on oil related undertakings given its own complete lack of oil resources.

This credit rationing exercise is part of the government's effort to dilute the power of the chaebols and to encourage them not to over-diversify. But adding crude administrative rationing of credit to centrally fixed interest rates at a time when the authorities are speaking of interest rate liberalisation seems contradictory. To add insult to injury, the chaebols can revise and change their choice of core activities every three years thus opening up a further venue of misuse of these rationed funds and credits. To paraphrase a line from a well known play "To fix interest rates is unfortunate but to ration bank credit as well smacks of carelessness".

Financial and economic news in Korea during 1990 were dominated by the activities of the construction and housing sectors. The residential property market in Korea is now extremely distorted as a result of government price controls and land use policies. There were four broad developments which led to this situation. Firstly, the

rapid urbanisation of the country in general and Seoul in particular led to continuous increases in the demand for both land for residential use and for housing. Secondly, the credit rationing policies of the state throughout the 1980s, either directly or through its influence on the state dominated banking sector, restricted severely the supply of mortgage finance. The few funds which are available mean that only as little as 20% of the value of houses or apartments can be financed through bank loans. Thirdly, the state sector built and sold houses at subsidised prices for low income families. Indeed the government pledged in 1987 to build 2 mn units by 1992 with 500,000 of these being completed during 1991 alone. Although there are restrictions on the resale of these houses, the second hand market for them is free, and prices there are, on average, nearly double of that in the controlled sector. Inevitably profitable arbitrage operations were set up, which, coupled with the dearth of mortgage finance, led to better off house buyers who could raise the cash buying these houses for resale. As these units were allocated in the first place through a queueing system, a secondary market also developed for places in the queue! Fourthly, the government has imposed restrictions on price increases for new houses built by the private sector. Developers attempted to protect their margins by building bigger apartments or houses (which are cheaper to build per square foot) and concentrated their developments in areas of relatively inexpensive land, i.e. away from conurbations where the demand was in the first place. As these price rise ceilings apply only to new houses, the secondary market reflected, once again, scarcity and led to further arbitrage opportunities. Buying cheap in one market and selling dear in another is a perfectly acceptable practice. In the case of Korea it did not lead to prices equalising but to poor publicity for, and resentment towards, the government and the construction sector.

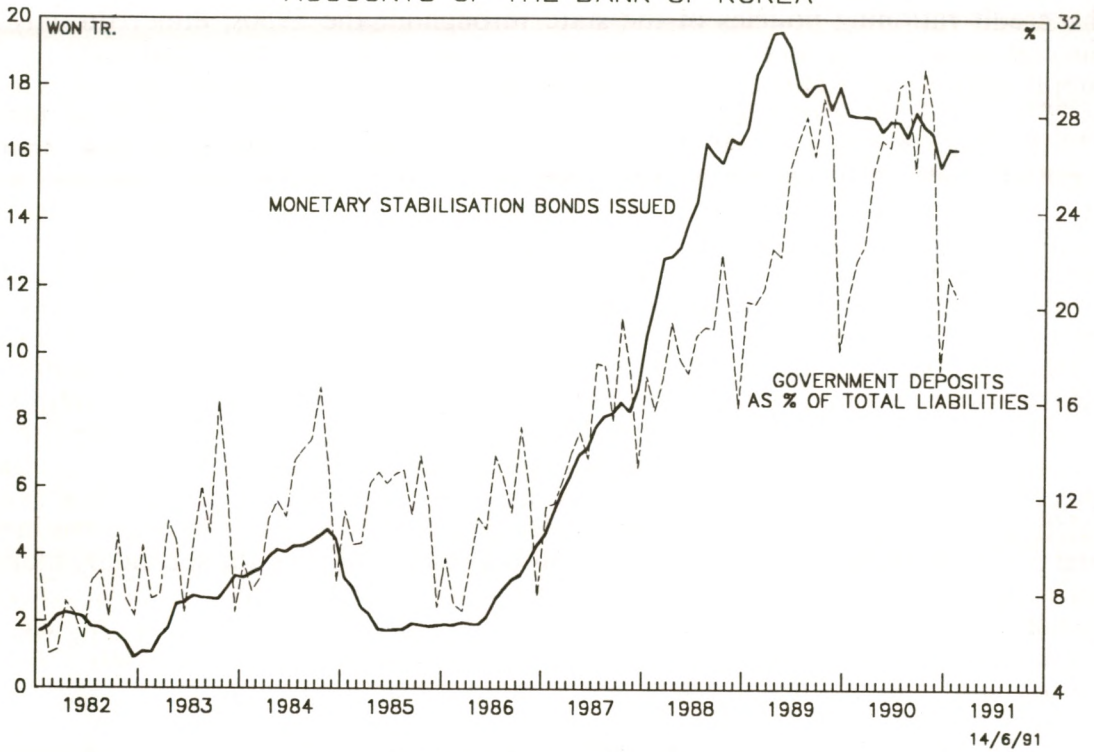
The excess demand for housing has spilled over to the price of land. Chaebols have been accused of buying and hoarding land. Government directives instructing them to sell their "idle" land holdings have only been partially complied with. At the end of March 1991, 46 major chaebols had disposed of only 60% of their "idle" land. To add to the already distorted credit market these chaebols were penalised by being charged by their bankers (on government's instructions) penalty rates on their general loans. The amount of loans subject to these penalties equalled the amount of the undisposed of land.

In sum the banking system, housing market and to a lesser extent the financial system in Korea are still subject to arbitrary and distorting regulation. Interest rates in particular are artificially low both for bank loans and deposits and pricing controls have distorted the residential property market.

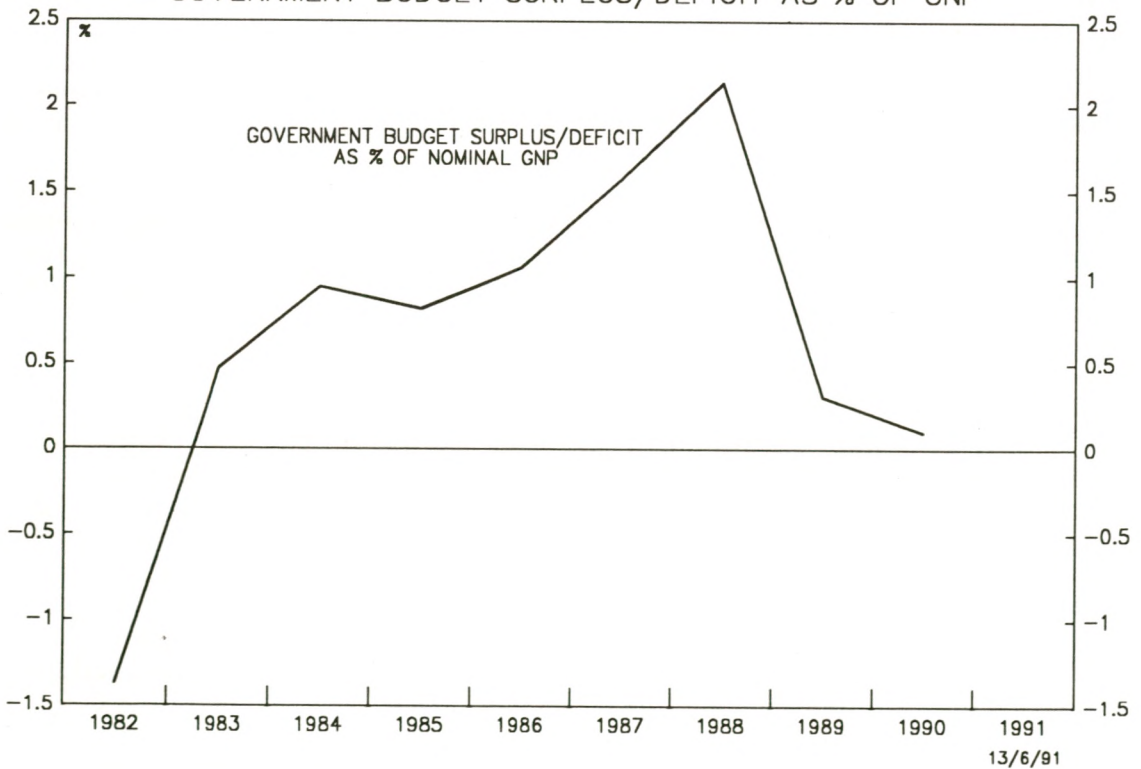
Monetary and Fiscal Policy

The Korean authorities have made extensive use of Monetary Stabilisation Bonds (MSB) as instruments of sterilisation of the inflow of funds associated with surpluses in the balance of payments. As Chart 13 shows the amount of these bonds issued increased sharply from the middle of 1986 until the middle of 1989, the period matching the rise and the beginning of the fall of Korea's current account surplus (Chart 1). These bonds are liabilities of the central bank in Korea, and by being sold to commercial banks reduce the size of the monetary base and hence the ability of these banks to create deposits by lending. The amount of MSB issued declined since 1989 Q2 as the current account surplus disappeared and then turned into a deficit.

S.KOREA: CHART 13
ACCOUNTS OF THE BANK OF KOREA



S.KOREA: CHART 14
GOVERNMENT BUDGET SURPLUS/DEFICIT AS % OF GNP



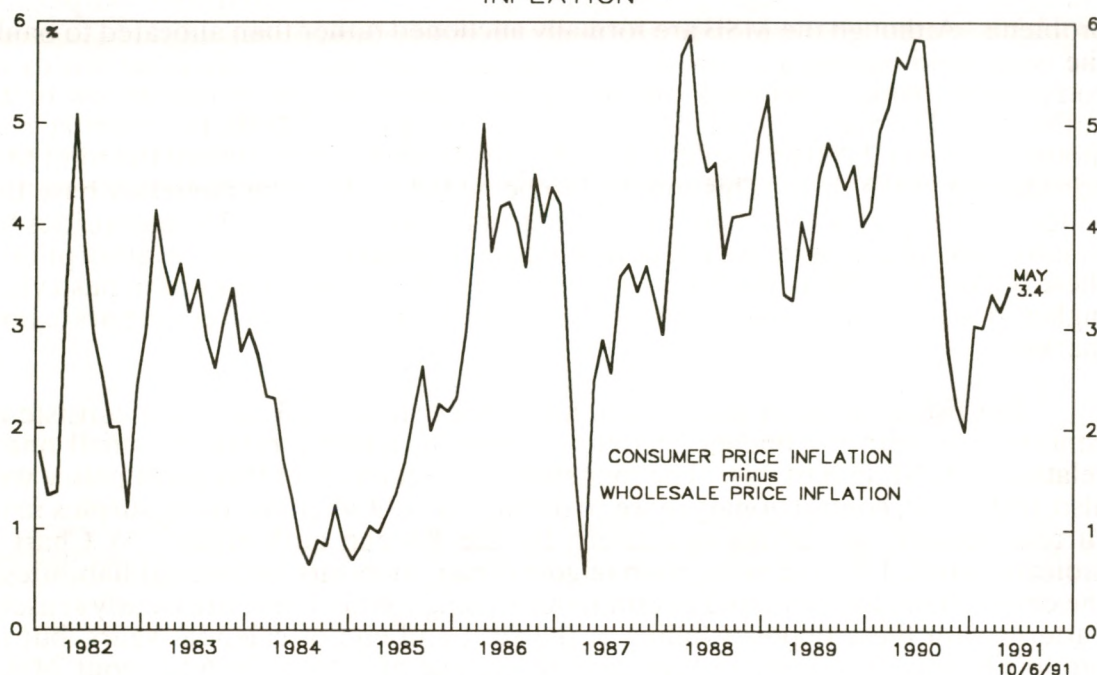
In February 1991 MSB accounted for nearly 39% of all the liabilities of the Bank of Korea. The sheer amount of these bonds meant that they created their own peculiar problems. Although the MSB are formally auctioned rather than allocated to banks, the issue yield has been below that of their secondary market. In other words the commercial banks subsidised the cost of the monetary policy operations of the authorities. Despite the artificially low interest rates of the MSBs, their service costs mounted to over 2,000 bn won in 1989, or equivalently to about 10% of the total MSB outstanding at the time. This sum had to be added back to the monetary base thus cancelling out part of the desired restraining impact on liquidity. The authorities had to introduce an extensive system of facilities in order to encourage the absorption of these bonds by nonbank investors. The outcome of these activities was to push yields higher in the secondary market to the detriment of the relatively free corporate bond market.

The fiscal stance of the Korean authorities since 1983 has been consistently conservative, with the budget exhibiting a surplus, albeit a relatively small one in relation to GNP (Chart 14). The monetary consequences of this fiscal policy were also, in general, contractionary more so during 1987-89 when the rising surplus in the current account was of major concern for the Korean authorities. As Chart 13 indicates, since 1987 the proportion of government deposits to the total liabilities of the central bank has exhibited a continuously rising trend. There are clearly seasonal patterns with these deposits falling at the start and end of calendar years, but the proportion has risen from an approximate average of 10% in 1986 to about 24% in 1990. As the accumulation by the government of deposits with the central bank subtracts from the overall liquidity of the banking system, the overall monetary constraint in Korea is tighter than the behaviour of the MSB issued alone would indicate. For example, during 1989 MSB outstanding increased from won 16.2 bn to won 18.0 bn whilst government deposits also rose from won 5.7 bn to 7.2 bn (yearend figures). In 1990 MSB outstanding decreased to 15.6 bn with government deposits increasing marginally to won 7.4 bn. For the first two months of 1991 for which data are available, the average amount of MSB stands at won 16.1 bn and government deposits at won 8.7 bn.

The main preoccupation of the authorities is to maintain the M2 money growth at the 17-19% range in order to contain price rises and thus influence wage negotiations and the profitability of exports. In the case of exports, as Chart 2 shows, the Real Effective Exchange Rate for the won turned up sharply during 1991 Q1 whilst the nominal rate continued to fall against the US dollar. The declining inflation rates since January 1991 may help to reverse this erosion of competitiveness of Korean exports. At the same time, however, the combination of a tight monetary policy, loss of competitiveness overseas and the historically high nominal wage increases achieved during 1990 have impacted negatively on profit margins. An approximate quantification of this pressure on profit margins can be arrived at by examining the difference between consumer and wholesale price inflation. If the difference narrows this indicates that producers of goods and services do not pass on fully to consumers increases in their costs (differences in the construction and weighting of these indexes notwithstanding).

As Chart 15 indicates there was a sharp drop in the CPI-WPI differential during

S.KOREA: CHART 15
INFLATION



August-December 1990. Taking the 1982-1991 (May) period as a whole, the average differential stood at 3.19 percentage points with a standard deviation of 1.35. The current differential (May 1991) is therefore roughly at the average level. Even if it were to rise, it would on average not exceed 4.75 percentage points ($3.4 + 1.35$), still well below the peaks achieved in mid 1988 and 1990.

Although this is a simple and rough approximation it does indicate that profits margins are under pressure and are unlikely to be restored during 1991 to their mid 1990 levels.

The Way Backwards?

The readjustments currently taking place in the Korean economy can be summarised under three broad headings.

Firstly, an export-led economy has turned to domestic sources of demand which are unlikely to be able to maintain the previous tempi of GNP growth. Part of the explanation for the decline in the importance of the export sector is the rise in the nominal and real effective exchange rate during 1986-1989. The other part rests with the effects of direct controls over the banking and financial system which led to highly distorted relative asset prices which discouraged personal savings.

Secondly, a combination of political (democratisation) and economic forces (militant unions) shifted the distribution of GNP towards wages and salaries. The rising real disposable incomes, in the absence of reasonable yields on financial assets (such as bank deposits) diverted household expenditures partially towards real estate and towards consumption.

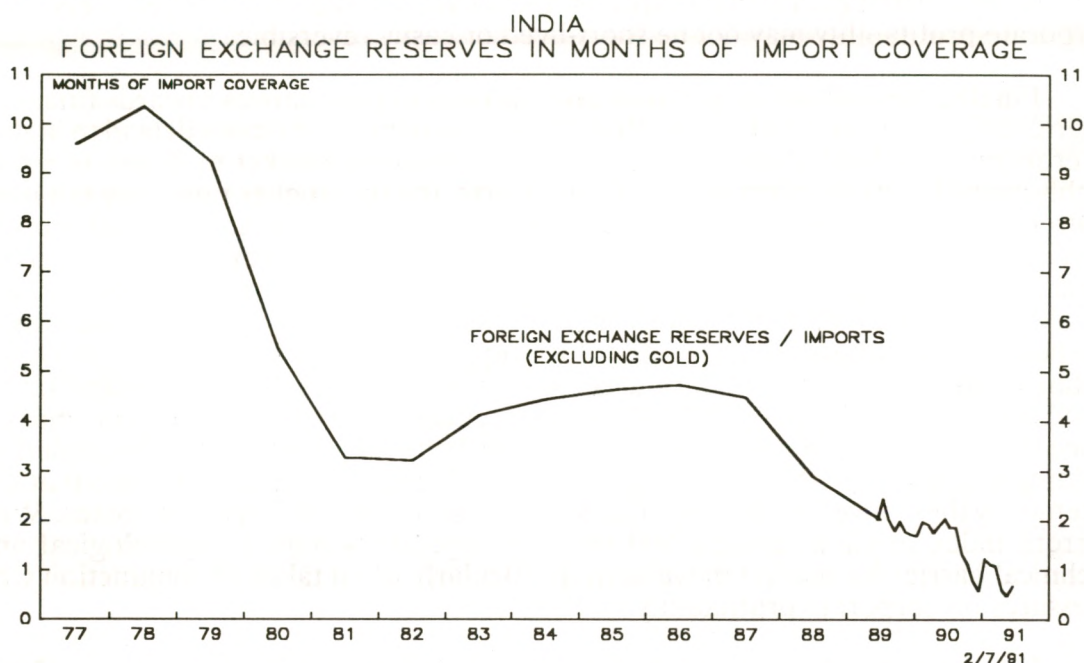
This shift in the distribution of the national product may represent more than a cyclical redistribution of the shares of the GNP. Hence the consequences for corporate profitability may not be short-lived or easily reversible.

Finally, the authorities are slow and cautious in their moves towards financial liberalisation. They are fully aware that a decontrol of interest rates will lead to higher interest rates on bank deposits and loans. The property market in Korea is not as highly geared as its counterparts in US and Japan and thus higher rates may not have a direct impact. Furthermore property related companies represent a small proportion of the capitalisation of the equity market. There will, however, be a shift away from real estate as an investment vehicle as financial assets, including shares, are revalued. Unfortunately the equity market has to bear its full share of the consequences of the authorities' misguided stock support exercise in December 1989. As financial institutions, investment trusts etc. as well as the Stock Market Stabilisation Fund (which was set up in April 1990) had been encouraged to enter the equity market since October 1989 and after the December 1989 official intervention, they ended up holding nearly 15% of the market capitalisation. There is a general consensus that any attempt by these investors to sell at index levels less than 850 will result in losses. With current index levels at around 600 this now represents both a psychological and technical barrier for market movements particularly when taken in conjunction with pressures on corporate profitability.

Financial deregulation in Korea will not be a painless affair even if the authorities introduce it as slowly as they can. There are, however mounting pressures not least from the United States and the GATT round of talks on the international trade in services which will not allow for a protracted period of adjustment. The opening up (at least in a de facto sense) of the equities market to direct foreign investment will force the liberalisation of the banking system and with it the decontrol of the politically sensitive real estate sector.

FORECAST: The Korean authorities will maintain a tight monetary and fiscal stance for the rest of 1991. The few market-determined interest rates will remain high. The credit squeeze in the controlled banking sector will take the form of lengthening queues of hopeful loan applicants, excluding the core companies of chaebols. Company profitability is unlikely to improve during 1991 despite the buoyant domestic demand because of the past erosion of Korea's competitiveness overseas and the progressively limited opportunities to pass on wage and cost increases to consumers in a period of tightening liquidity and credit. It would now follow that the performance of the equity market will remain uninspiring for the rest of 1991. This will be even truer if the authorities are forced to either rescind their decision not to decontrol interest rates during 1991 or to introduce these measures at a rapid pace during 1992. In either case the Korean equity market will not be able to avoid the shock of higher interest rates when that time comes.

INDIA: NEW GOVERNMENT, SAME OLD PROBLEMS

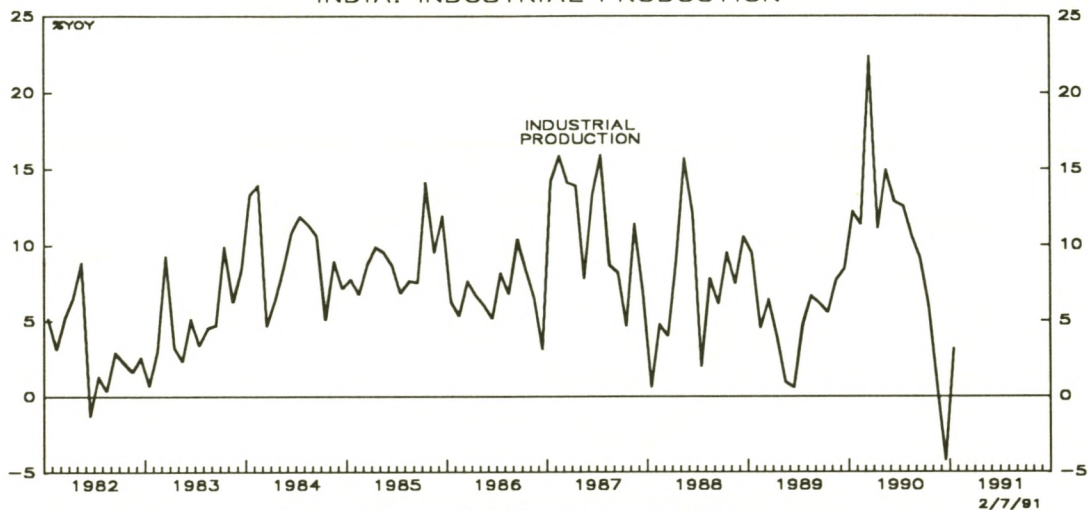


The new minority Congress government of Mr. P.V. Narasimha Rao, elected in part on the back of a sympathy vote following the assassination of Rajiv Gandhi, faces the perennial Indian problems of large budget and current account deficits, a US\$70 billion external debt and meagre foreign exchange reserves. It is this lack of reserves that is of most immediate concern as India remains dangerously close to defaulting on its foreign debt for the first time. In recent months, the country has received loans of US\$1.78 billion from the IMF and US\$300 million from Japan. In addition it has imposed an almost total freeze on imports and sold 20 tons of gold for US\$200 million, but reserves have continued to fall and now stand at around 2 weeks' import cover.

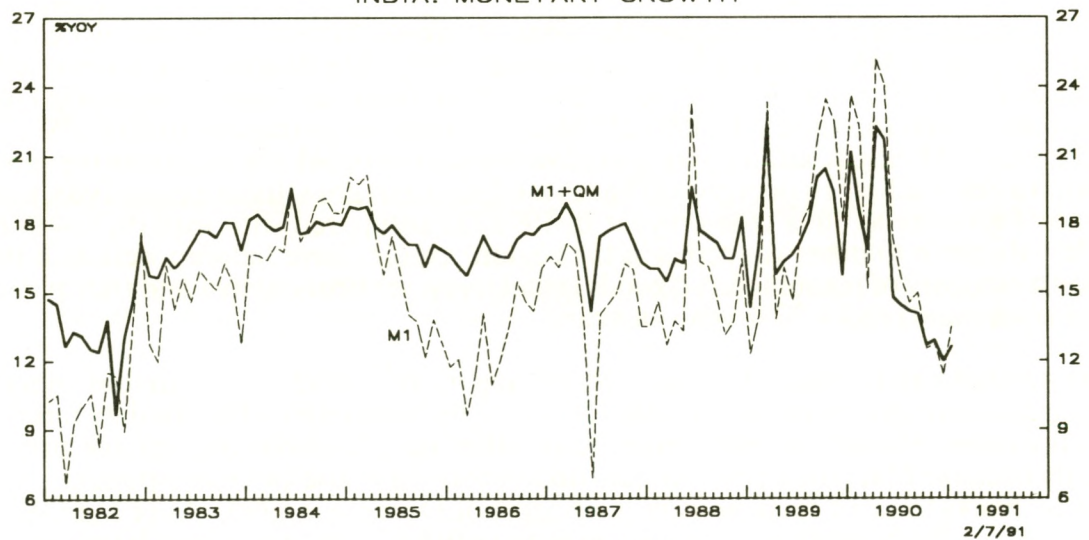
India's attempts at raising fresh loans have been made all the more difficult by its uncertain political climate and the downrating of its debt by international agencies three times since last October. Nevertheless, the IMF is set to release a further US\$2 billion subject to the passing of a "acceptable" new budget, and the incoming Finance Minister Mr. Manmohan Singh has already applied for an additional US\$5-7 billion. India has already pre-empted possible IMF demands for a devaluation of the Rupee by recently announcing two adjustments down in the currency against the US\$ totalling 20%. The Rupee had already fallen 15% against the US\$ this year and following these latest devaluations now stands at Rupee 26 to US\$1. However, with a worsening current account deficit and high inflation it can be expected to depreciate further.

Strangely enough, the desperation of the Indian authorities gives rise to cautious optimism that they may be forced to implement fundamental economic reforms. IMF conditions will certainly stipulate serious attempts to curb a budget deficit of 9% of GDP, while restrictions on imports and foreign investment -- a paltry US\$100 million last year -- may well be relaxed. This should help reverse some of the collapse in industrial production, but with inflation running well into double digits, a relaxation of the Reserve Bank's tight monetary policy is unlikely.

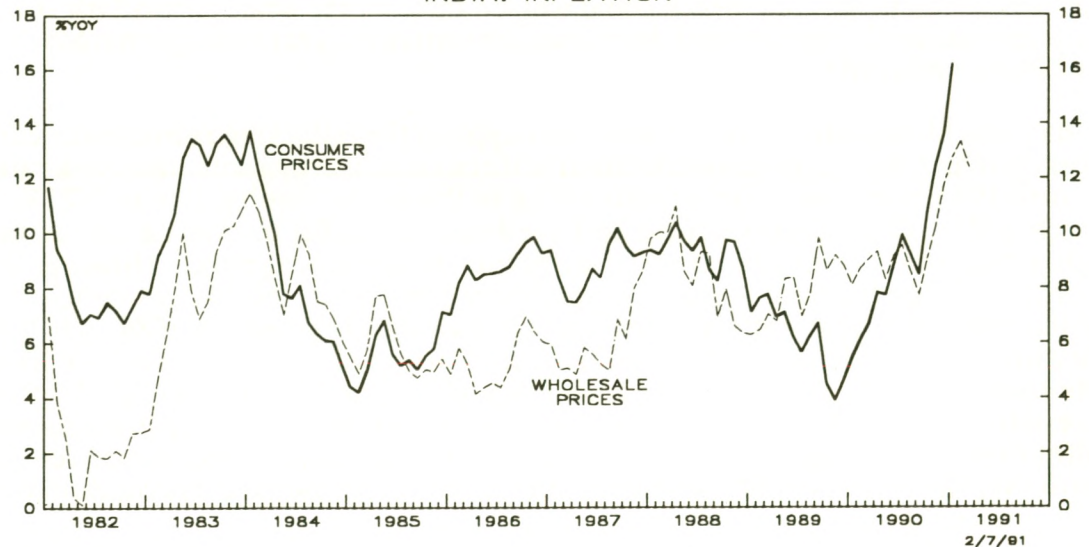
INDIA: INDUSTRIAL PRODUCTION



INDIA: MONETARY GROWTH

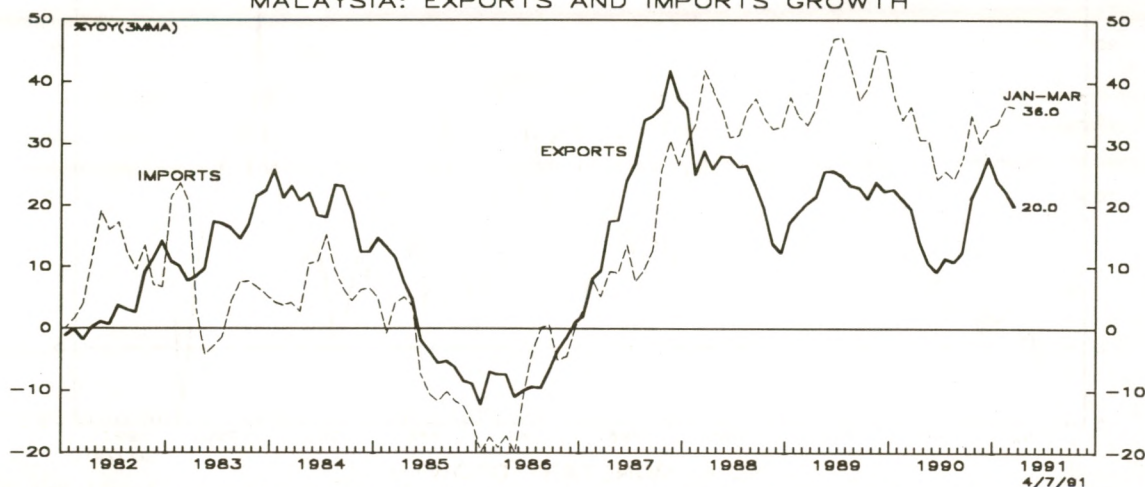


INDIA: INFLATION



MALAYSIA: SYMPTOMS OF OVERHEATING PERSIST.

MALAYSIA: EXPORTS AND IMPORTS GROWTH

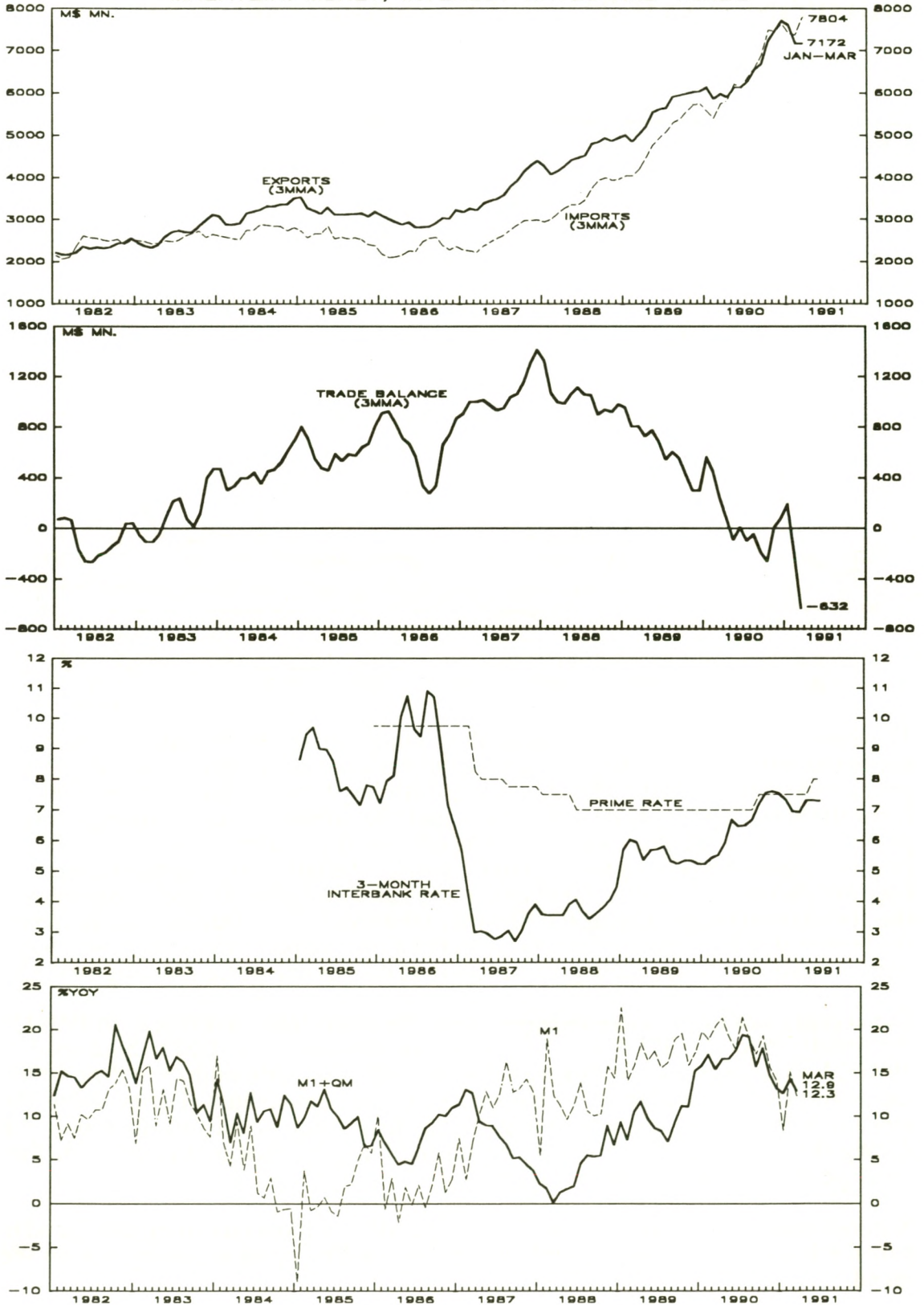


Malaysia has continued to display the signs of excess domestic demand which we forecast in our AMM article of January-February 1991. The clearest macro-economic indicator of overheating is the deterioration in the trade and current accounts (see chart above and top right). In 1991 Q1 Malaysia recorded a trade deficit of M\$ 1.79 billion (about US\$ 640 million) compared with a surplus of M\$ 716 million in the same period a year earlier. Import growth has exceeded export growth since early 1988, with imports growing at 36% year-on-year in 1991 Q1 compared with export growth of 20%. Relative to other countries in the region, exports have held up well with the largest category of manufactured goods (machinery, semiconductors and transportation equipment) rising 27% year-on-year

The fundamental reason for the overheating is the acceleration in the money aggregates from just over 10% in 1988-89 to 20% by September 1990. To date this has mainly been reflected in asset prices, and rather little in goods and service prices, partly because Malaysia's price indices do not contain house price components, and partly thanks to tariff reductions in the budget of December 1990. As of May 1991, Malaysia's CPI showed a 4.3% increase compared with 3.4% a year ago -- by no means a serious problem, but one which could worsen through the year, particularly if the currency weakens further as it has done since the start of the year (falling from M\$ 2.70 per US\$ to nearly M\$ 2.80).

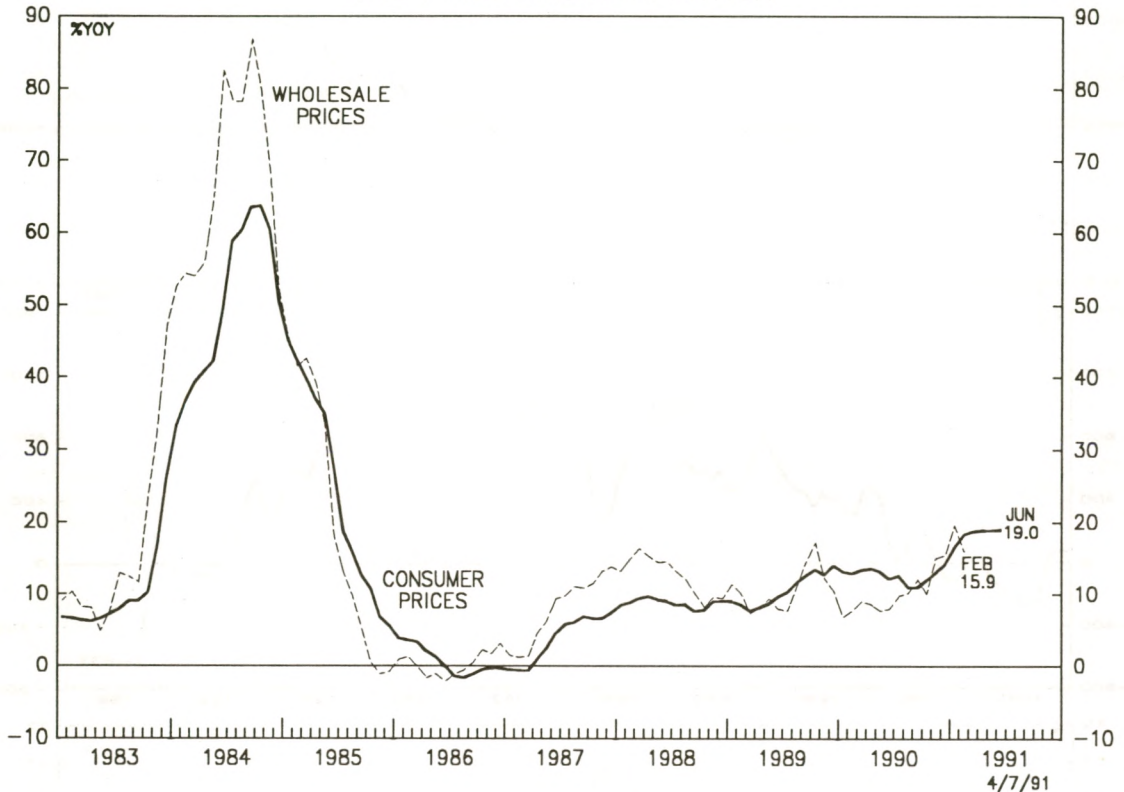
To date the Malaysian authorities have only applied the mildest of measures to curb excess demand. Interest rates were raised in three steps, starting with interbank rates in April 1991, and most recently with a hike in the prime lending rate to 7.75% in March 1991. These moves appear to have been successful in slowing the money aggregates from 20% to around 12% (see bottom two panels at right). However the external trade and current account will probably continue to show larger deficits for the balance of this year, reflecting two years of easy money growth in 1989 and 1990. We expect a trade deficit of M\$ 8 billion and a current account deficit of M\$ 10-11 billion for the whole of 1991. These deficits would only become a serious problem in the event that Japanese and other foreign capital inflows began to dry up in the second half of 1991. So far there is little sign of that, but if financial conditions in Japan remain restrictive, the impact could become significant, in which case liquidity conditions in Malaysia would tighten severely.

MALAYSIA: MONEY, INTEREST RATES AND TRADE



PHILIPPINES: NATURAL AND MANMADE DISRUPTIONS

THE PHILIPPINES: INFLATION

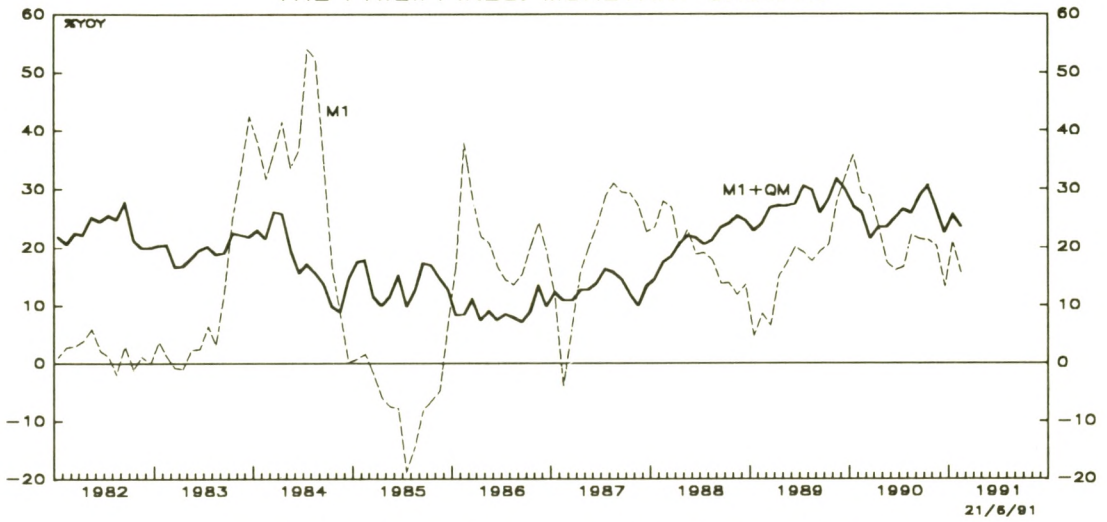


There are some encouraging signs regarding inflation in the Philippines. As the chart above indicates consumer price rises have flattened out during June whilst wholesale prices may have peaked. Money stock growth has been declining since 1990 Q4 (opposite page, upper chart). The news that the authorities are contemplating a phased reduction of bank reserves starting with the third quarter of this year will not help to keep money stock growth under control. The fall in interest rates (opposite page middle chart), however, may be shortlived as it took place following a surplus in the government budget during the first four months of 1991. During May, however, the budget was back into deficit. Growth of exports remains weak (opposite page, bottom chart) whilst the GNP grew at less than 0.20 of one percent during 1991 Q1.

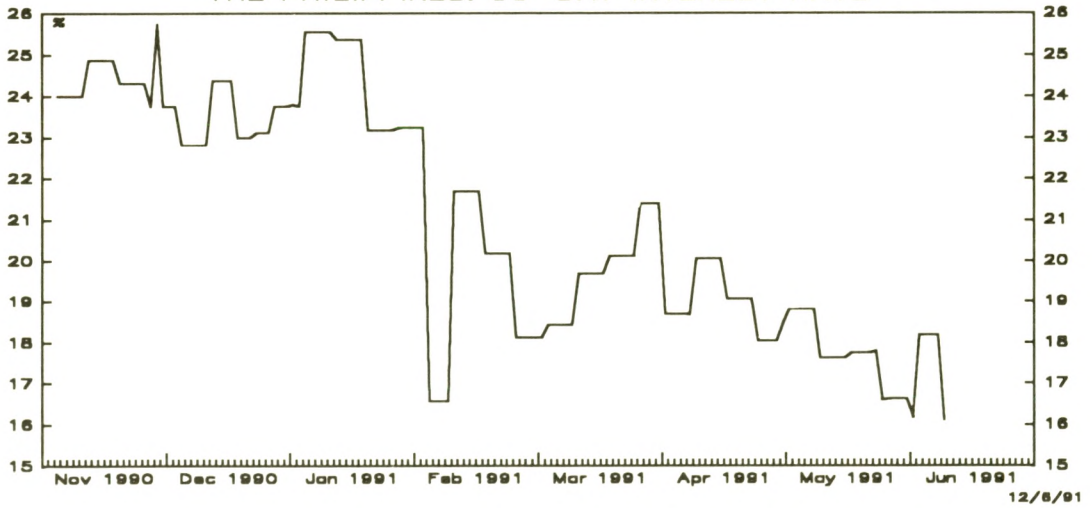
The recent volcanic eruption is likely to cause the trade deficit to worsen. In 1991 Q1 the deficit stood at US\$1.01 bn, a slight improvement over the US\$1.15 bn level of 1990 Q4. The disruption of the economy will affect exports whilst the drop in the tourist trade will have a longer term impact on the current account. Furthermore, the inevitable increase in government spending to provide relief and to repair the damaged infrastructure will ensure a growing budget deficit and possible further pressure on the growth of money stock.

Natural disaster struck at a time when a number of indicators such as inflation, and in part the budget deficit, were pointing out that the Philippine economy was on the mend.

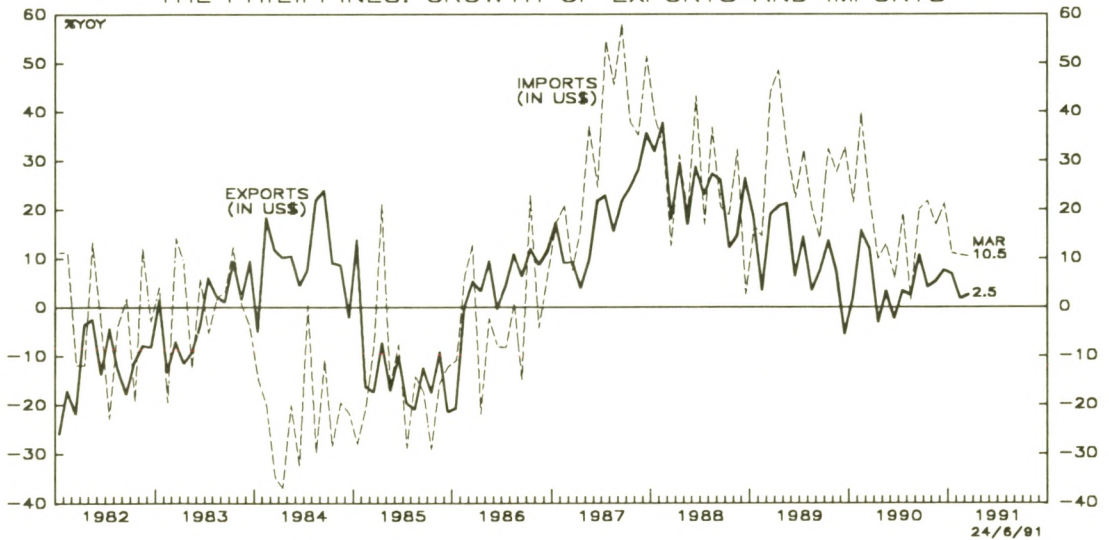
THE PHILIPPINES: MONETARY GROWTH



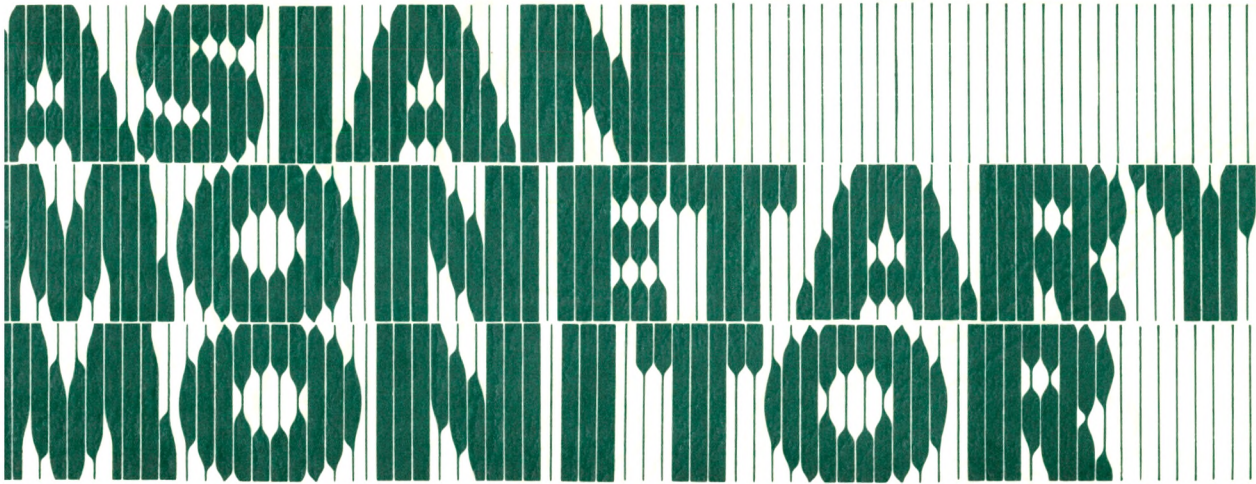
THE PHILIPPINES: 90-DAY INTEREST RATE



THE PHILIPPINES: GROWTH OF EXPORTS AND IMPORTS







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REGIONAL SURVEY

WHAT RATIONALE FOR AN ASIAN REGIONAL TRADE BLOC?

Introduction

During the past couple of years there have been two major proposals for the formation of some kind of Asian regional group, either for trade, or for consultative purposes, among the countries of the Asia-Pacific rim. So far the proposals for a trade bloc have not made very significant progress due to the disparate interests and priorities of the various participants in the discussions. APEC, the Asia-Pacific Economic Cooperation group, is now in operation and will be expanded in November 1991. This article first sets out the case for free trade and makes some general observations about the benefits which the free-trade regime of the GATT has brought to the world as a whole. Second, we examine the crucial question of whether, and under what conditions, the formation of trade blocs can be consistent with the objectives and framework of GATT. Third, the rationale for an Asian trade bloc is considered in the light of the characteristics of the Asian economies (i.e. comparative advantage, income level etc.) Finally we assess the likelihood of such a regional trade bloc emerging within the next decade.

1. The Case for GATT-based Free Trade

Countries or firms or individuals engage in international trade because they can buy goods or services more cheaply abroad than at home. Free trade permits countries to specialise to the maximum possible extent, using their resources more efficiently to produce those goods and services where they enjoy a comparative advantage. At the same time, specialisation yields benefits through the economies of scale because high volume production lowers average costs. On the other side, maximising productive efficiency and exchanging its output for those goods and services which a country cannot produce so cheaply, enables a country and its people to increase their consumption.

The arguments in favour of free trade were perhaps best summed up by Henry George in "Protection or Free Trade", written over 100 years ago (in 1886). He wrote, "Free trade consists simply in letting people buy and sell as they want to buy and sell. It is protection that requires force, for it consists in preventing people from doing what they want to do. Protective tariffs are as much applications of force as are blockading squadrons, and their objective is the same -- to prevent trade. The difference between the two is that blockading squadrons are a means whereby nations seek to prevent

their enemies from trading; protective tariffs are a means whereby nations attempt to prevent their own people from trading. What protection teaches us is to do to ourselves in time of peace what enemies seek to do to us in time of war."

In the years since World War II free trade has been promoted through the framework of the GATT, the General Agreement on Tariffs and Trade signed in Geneva in 1947, and which came into effect on 1 January, 1948. The GATT is a multi-lateral agreement between countries setting out rules of conduct for international trade, and providing a forum for negotiations (also on a multi-lateral basis) on trade disputes and the gradual elimination of tariffs and other barriers to trade. The key principles of GATT rules are non-discrimination and reciprocity which, if carried out by all signatories, would surely lead to the liberalisation of world trade. All contracting parties are bound by the GATT's most favoured nation clause which requires extension to all other nations the same terms as are enjoyed by any one country which enjoys the best terms. The only exceptions are (1) customs unions and free trade areas which must be individually reported to GATT (by 1988 over 60 such preferential trade agreements had been notified to the GATT), and (2) a general exemption enabling developing countries to trade with developed countries on a non-reciprocal basis. Under GATT protection may be extended only through customs tariffs, in effect outlawing import quotas or other restrictive trade practices, although in reality non-tariff restrictions have proliferated in the past two decades.

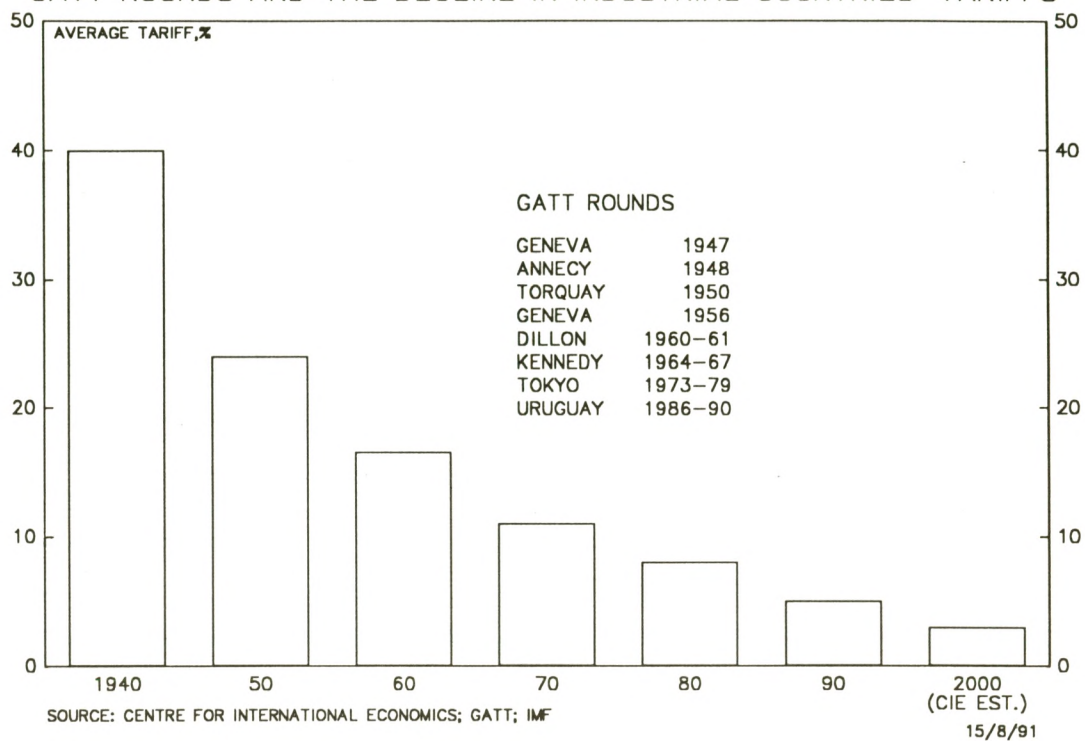
As listed in Chart 1, there have been 8 rounds of GATT negotiations, and as the chart shows these have resulted in substantial reductions in the average level of tariffs for manufactured goods which have declined from about 40% at the time of GATT's formation to about 5% today. Despite GATT's success in the area of manufactured goods there are substantial gaps in GATT's coverage, and GATT has also been outmanoeuvred by the introduction of a variety of non-tariff barriers.

From the time of its foundation, GATT excluded trade in agricultural goods, mainly at the request of the United States which required high tariffs and/or import quotas to maintain domestic farm price supports. Also, since the 1960s the international textile and garment trade has been regulated -- first by the Short Term Arrangements, followed by the Long Term Arrangement, and subsequently by a series of Multi-Fibre Agreements (MFAs).

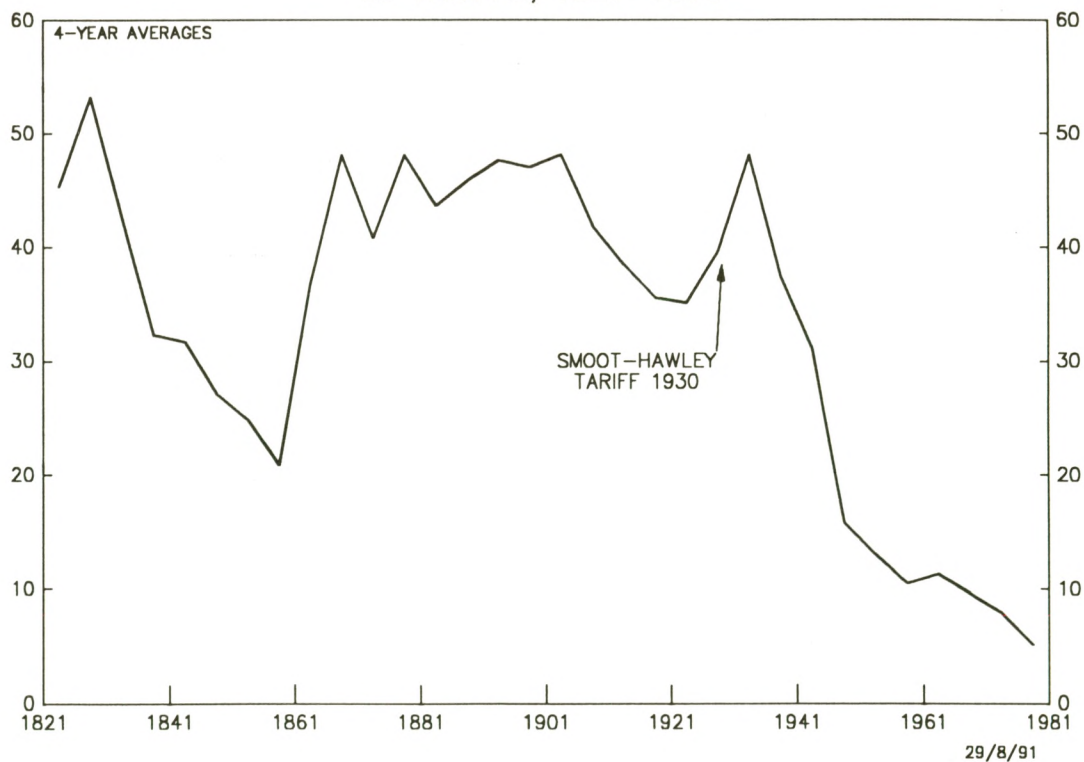
Aside from creating these two exemptions, member countries of GATT have devised methods of restraining or managing trade by other protectionist methods such as Voluntary Export Restraints (VERs), under which exporters agree to place quantitative limits on their exports to a particular country. Strictly speaking these are outside GATT's mandate because they are voluntary and supposedly self-imposed, but they have been widely used by the US to restrict imports of colour TVs, autos, steel and machine tools.

Another procedure outside GATT is the anti-dumping device, a law passed by any country to prohibit so-called "unfair trade". The government in question usually threatens some retaliatory duty if a foreign product is sold in that country for less than the price charged in the domestic market. Initiated by the U.S., anti-dumping laws are frequently used by the E.C. and increasingly by other countries -- even against the U.S. itself.

REGIONAL SURVEY: CHART 1
GATT ROUNDS AND THE DECLINE IN INDUSTRIAL COUNTRIES' TARIFFS



REGIONAL SURVEY: CHART 2
US TARIFFS, 1821-1979



To maintain the momentum of GATT the focus of discussions has had to be widened to include new topics at each round. Thus the Kennedy round, held at Geneva between 1964 and 1967, was the first occasion when tariff reductions were negotiated on whole groups of goods, in contrast to previous negotiations which had proceeded on an item-by-item basis. The Tokyo round (1973-79) considered both tariff and non-tariff barriers, while in the Uruguay round (1984-90) the U.S.A. has focused particularly on attempting to bring both agriculture and textiles inside the GATT, as well as to include intellectual property rights and international trade in services within the ambit of GATT.

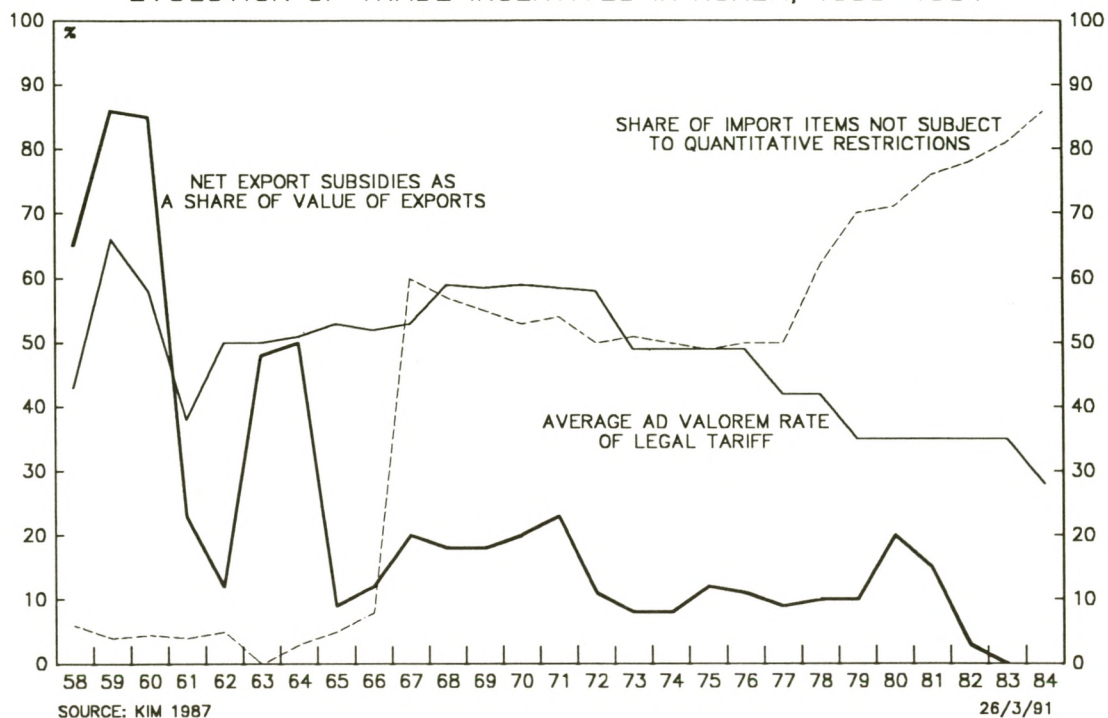
Chart 2 shows how US tariffs have declined dramatically since the 1940s, largely due to the GATT negotiations. However, in recent years the growth of numerous bilateral agreements such as VERs (Voluntary Export Restraints) has effectively given US producers a substantially higher level of protection than that indicated in this chart. Nevertheless there are countries in Asia where trade has definitely become freer over the years. Chart 3 shows several indicators of trade protection for Korea, illustrating a steady, step-wise reduction in tariffs during the 1970s, sharp reductions in export subsidies in 1961, 1965 and 1981-82, and the steady expansion since 1977 of the share of imports not subject to quantitative restrictions.

Chart 4 shows the growth of world GNP in real terms and the growth of trade volumes during the GATT era. Under the relatively free trading regime sponsored by GATT world trade volumes have consistently grown faster than world real GNP, reflecting the gains from trade due to specialisation and the economies of scale referred to above. The chart appears to suggest that slower GNP growth is associated with substantially slower trade growth, while faster GNP growth accompanies dramatically faster trade growth. Which is cause and which is effect? Work done by David Greenaway at the World Bank ("Characteristics of Industrialisation and Economic Performance under Alternative Strategies") suggests that over the period 1973-85 countries like Hong Kong, Singapore and Korea which had strongly "outward oriented" trade strategies grew faster than those countries like Malaysia or Thailand which had only "moderately outward oriented" trade strategies. Both groups grew faster on average than those countries which he classified as having "moderately inward oriented" strategies (e.g. Indonesia, Pakistan, the Philippines and Sri Lanka) or "strongly inward oriented" strategies (e.g. Bangladesh, India). In short, cross country data suggest free trade is good for growth while protectionism acts as a drag on growth.

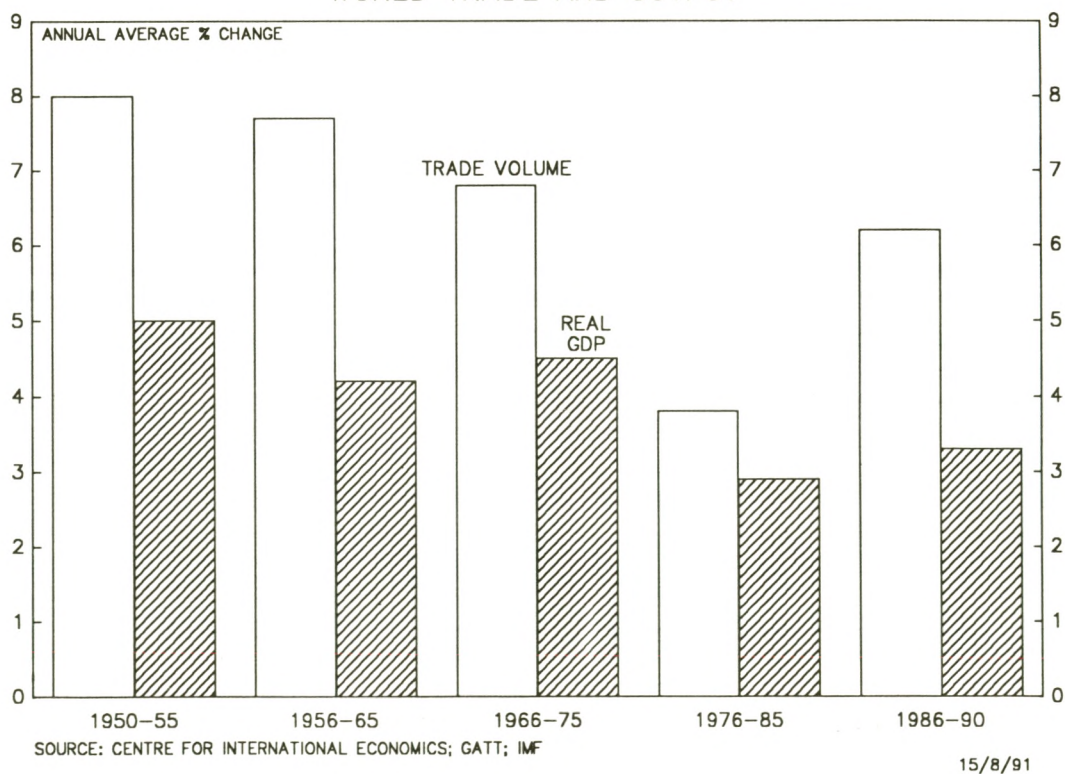
2. Can Regional Trade Blocs Be Consistent with GATT, or Moves toward Freer Trade?

The obvious problem about the creation of regional trade blocs is that they might lead to the raising of common external tariffs as well as non-tariff barriers by the participating countries, leading possibly to the sort of pre-war tariff levels represented by the Smoot-Hawley tariffs imposed by the United States in 1930 (see Chart 2). This in turn would result, it is said, in a serious worldwide recession or even a depression in much the same way that the Smoot-Hawley tariff is alleged to have touched off the world depression of the 1930s. Aside from being highly implausible, this kind of anxiety is based on a misunderstanding of the real causes of the Great Depression of 1931-33.

REGIONAL SURVEY: CHART 3
EVOLUTION OF TRADE INCENTIVES IN KOREA, 1958-1984



REGIONAL SURVEY: CHART 4
WORLD TRADE AND OUTPUT



First, while an Asian regional trade grouping might raise tariffs to a common level (which might be the highest common tariff level of the participant countries), it seems quite unlikely that any group of Asian countries would entirely reverse the achievements of the GATT over the past four decades. What is much more plausible is that an Asian regional trade grouping, once established, might raise external tariffs slightly (say, 5% - 10%), so the proper comparison is between the level of tariffs before the formation of the regional bloc and a realistic level of tariffs after the creation of the bloc.

Second, the damage done by the notorious Smoot-Hawley tariffs is frequently exaggerated. As shown in Chart 2 U.S. tariffs rose from an overall level of approximately 40% to roughly 50% between 1930 and 1934. No doubt this did adversely affect trade volumes by discouraging international trade, but the real damage was done by the simultaneous 30% monetary contraction in the USA between 1930 and 1933 which caused nominal incomes to plunge by a similar magnitude, and which in turn led not only to comparable reduction in US imports between 1930 and 1933, but to a similar -- though not so severe -- monetary tightening in other major industrialised countries. As a result of the monetary tightening elsewhere there was also a reduction in nominal incomes abroad, depressing demand for US exports. Therefore a correct reading of the determinants of the Great Depression in the USA (and elsewhere) requires an assessment of the separate contributions of both the monetary contraction and the tariff hikes. It follows that unless the tariff hike by an Asian regional bloc was extremely large, and/or unless there was a simultaneous monetary disturbance which itself caused an economic downturn, the formation of an Asian regional trade bloc would -- on its own -- probably not lead to a serious economic downturn, though it might cause growth to slow down.

As indicated earlier, there are arrangements under GATT which do permit regional blocs to be formed under quite strict conditions. Article XXIV permits only free trade areas and customs unions with 100% reduction of trade barriers among the members. This effectively allows discrimination in favour of the participants provided that the dismantling of barriers between participants is absolute. The formation of the EC in 1959 was permitted under this formula, as was the proposed Latin American Free Trade Area (LAFTA), which unfortunately never got off the ground. More recently the ASEAN preferential trading arrangements (1977), the Australia-New Zealand Closer Economic Relations Trade Agreement (1983), and the Canada-USA Free Trade Agreement (1988) have also been permitted under Article XXIV.

The risks implicit in these regional arrangements is that they will divert trade rather than create trade. As an example from the Asia-Pacific region, consider the effect of the Australia-New Zealand CER agreement on the manufacture of electrical white-goods such as refrigerators, cookers and other household appliances. Suppose there was a dominant manufacturer A of such goods in Australia which was less efficient than dominant manufacturer B in New Zealand. Before the trade agreement both were protected by external tariffs from competition from Japanese or South East Asian manufacturers. When CER was implemented it is quite possible that the New Zealand manufacturer B could have out-competed Australian manufacturer A to the point where B became the dominant supplier in both Australia and New Zealand. However, both Australian and New Zealand consumers would have been better off buying cheaper, more efficient white goods from Japan or South East Asia.

In other words New Zealand production has been diverted to Australia (or Australian consumer dollars have been diverted to New Zealand products), whereas in global terms the world would have been better off if trade between Japan and S.E. Asia on the one side and Australia and New Zealand on the other side had been created by the opening up of opportunities for Asian manufacturers to sell in Australia and New Zealand. The economic losses occur because in this particular example New Zealand businessmen would have invested in plant, machinery and equipment, etc. which were appropriate to a second-best product. From a global perspective this is clearly inefficient and misallocates resources. Thus agreements like CER can, if they do not simultaneously lower external tariffs, divert trade instead of create trade.

The conclusion is that regional trading blocs are only compatible with GATT and multi-lateral free trade arrangements if they (a) ensure total elimination of trade barriers among members, and (b) ensure a rapid lowering of common external tariffs to GATT-equivalent levels or lower. The particular problem in Asia is that many smaller countries still maintain substantial tariffs, quotas and other non-tariff barriers. If an Asian regional block were to be formed, countries like Japan would enjoy enormous advantages over their American or European rivals, and would therefore gain market share even though on a global basis they were not the most efficient producers. The problems encountered in securing the opening of the Japanese market would then be extended to the whole of Asia, which would surely be inconsistent with optimal international trading arrangements.

Regional trade blocs are understandably gaining more advocates on account of the difficulty of moving the complicated, multi-lateral, multi-product GATT negotiations forward. However, if member countries of an Asian regional bloc could agree to (a) eliminate internal tariffs, and (b) agree on common external tariffs which were set at the lowest level of any participating member, then the damage to world trade and an efficient allocation of resources would be minimised.

3. How might Asian Countries Benefit from a Trade Bloc?

Inter-regional trade and investment among Asian economies has been growing very rapidly in recent years. This is not only because per capita incomes of the people of the East Asia Pacific rim have been rising strongly, but also because the economies themselves enjoy strong complementarities. Asia includes countries with a very wide dispersion of per capita income levels, starting with Japan at US\$ 20,600 per capita, and going all the way down to Indonesia US\$470, China US\$310 and India US\$ 300. These income differences reflect differing levels of skill or productivity, and different comparative advantages such as capital stock, human capital and natural resource endowments. Generally speaking the countries which are the richest and the poorest in Asia have very meagre resource endowments, while the middle-income countries such as the ASEAN group appear to be best endowed with natural resources. These wide differences suggest that there should be large opportunities for trade between the natural-resource-endowed ASEAN group on the one hand, and both the wealthy countries and the poor countries on the other. Similarly, the capital-endowed, human-capital-rich countries should be expected to invest in the poorer countries which have ample cheap land and labour to make labour- and land-intensive products to export to the richer countries of Asia and the rest of the world. Therefore both through trade and investment, the exchange of capital goods, consumer goods and services, and intermediate goods should be expected to flourish in Asia. In other words, assuming

no barriers to trade and investment among countries in Asia, there ought to be ample scope for trade and investment without the need to create a separate, exclusive trading bloc.

Looking at the current structure of intra-Asian trade we find that much of the trade is between Japan and the 4 NICs (Korea, Taiwan, Hong Kong and Singapore), or between Japan and ASEAN. Apart from entrepot trade (e.g. Taiwan trade with China via Hong Kong) the NICs trade relatively little with one another, and the ASEAN countries also tend to trade mainly with the developed countries of Japan, America and Europe instead of with their rivals in South and East Asia. These observations suggest that the gains to be won from any regional trade grouping of smaller Asian economies are probably quite limited, if they exist at all. The main risk, therefore, of establishing an exclusive South East Asian trading bloc is exactly that specified in section 2, namely the risk that, because ASEAN's external barriers to trade are still quite high, an Asian trading bloc will result in substantial trade diversion and a resulting serious misallocation of resources. Conversely, if the ASEAN countries were to lower their external barriers jointly or independently, they should enjoy very rapid growth of trade and investment because they already have so many of the necessary conditions for success in place.

The case for establishing a consultative group along the lines of the OECD is, however, rather stronger. Every Asian country has an interest in upgrading the level of knowledge and understanding of its officials, particularly those concerned with the shaping of monetary, fiscal and international trade policies. However, such a group would benefit from a mandate or constitution for the organisation which (1) limited its activities to GATT-compatible objectives (such as the reduction of trade barriers etc.), (2) spelled out a free market agenda (the free movement of capital, the abolition of exchange control, the reduction of government relations and controls etc.), and (3) encouraged the exchange of information (but explicitly abstained from the imposition of uniform standards or the compulsory "harmonisation" programmes which have bedevilled the E.C.).

The conclusion is that there is little merit in creating an Asian trade bloc, and much potential for undesirable protectionism and trade diversion in such a bloc. However there is much to be said for the formation of a consultative organisation with a specific mandate for a pro-GATT, pro-free market stance. It is to be hoped that APEC, which recently announced the admission of China, Taiwan and Hong Kong from November 1991, will develop in this direction.

4. Prospects for an Asian Regional Trade Bloc

With the creation of the US-Canada Free Trade Agreement and the on-going negotiations between the US and Mexico for another free trade agreement on one side, and the prospect of a more cohesive European market in 1992 on the other, some South East Asian countries have been actively discussing the formation of an Asian trade bloc. This would imply the division of the world into a three-bloc trading system -- a European bloc, an American bloc and an Asian bloc. The most strongly canvassed proposal is that promoted by Malaysian Prime Minister, Mahathir Mohamad, for an East Asian Economic Grouping -- EAEG, to include Japan, Korea, ASEAN and the

TABLE 1

ECONOMIC COOPERATION GROUPS IN THE ASIAN REGION

1. Political/Economic Cooperation Groups

- ASEAN Association of South East Asian Nations (1967)
(Indonesia, Singapore, Malaysia, the Philippines, Thailand and Brunei since 1984)
- APEC Asia-Pacific Economic Cooperation (Nov. 1989)
(Australia, Brunei, Canada, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Thailand, USA plus China, Hong Kong and Taiwan from November 1991)

2. Central Banking Groups

- SEANZA South East Asia, New Zealand and Australia (1956)
(Australia, Bangladesh, China, Korea, India, Indonesia, Iran, Japan, Malaysia, Nepal, New Zealand, Pakistan, Papua New Guinea, the Philippines, Singapore, Sri Lanka and Thailand)
- SEACEN S.E. Asian Central Banks Research and Trading Center
(Indonesia, Korea, Malaysia, Myanmar (= Burma), Nepal, the Philippines, Singapore, Sri Lanka and Thailand)

3. Proposed Trade/Economic Cooperation Groups

- PAFTA Proposal Pacific Free Trade Area (1960s)
(US, Canada, Japan, Australia and New Zealand)
- EAEG Proposal East Asian Economic Grouping (Dec. 1990)
(= APEC minus US, Canada, Australia and New Zealand)

three Chinas -- the PRC, Taiwan and Hong Kong (see Table). Originally put forward in the wake of the stalemate in the GATT talks in Brussels in late 1990, such a grouping was discussed among ASEAN ministers at their recent meeting in Kuala Lumpur in July, but it has not made much progress for reasons of personality, politics and hard economics.

From the discussion of the structure of trade among Asian countries it would clearly be advantageous, if any Asian trade group were to be created, to include Japan because so many smaller Asian economies have a wide degree of complementarity with Japan, but are basically competitors with each other. (ASEAN itself has high tariff barriers and numerous infant industry protection schemes.) At the same time it is very unlikely that an Asian or Asia-Pacific group which included the US, Canada and Japan could be created because the US and Canada are unlikely to be sympathetic to such a grouping. Japan is therefore the key or swing factor. Only the presence of Japan in such a grouping would make the organisation viable and worthwhile; without Japan the organisation would have little merit as a trade group. Thus the attitude of Japan is going to be crucial. Could Japan be persuaded to decouple itself sufficiently from the US (in particular) to champion an Asian trade bloc which would surely be seen as a counterbalance to the North American Free Trade bloc or the EC bloc? The answer is almost certainly negative as long as Japan enjoys relatively free and open trading access to the North American and European markets. If, however, Japan were to be pushed into a corner where it felt that its producers were seriously disadvantaged in accessing -- for example -- the North American consumer, then it is quite possible that this would swing Japanese politicians sufficiently to favour joining an EAEG-type grouping.

Regrettably the interests of consumers are likely to be largely ignored in this type of decision. The interests of concentrated, vociferous and well-funded producer groups in Japan and South East Asia will almost certainly dominate the political debate, irrespective of the merits which unilateral reduction of trade barriers would bring to consumers throughout Asia. In the absence of far better representation of consumer interests in the Japanese political system it would seem that the emergence of an East Asian Economic Group will depend far more on the state of US-Japanese or European-Japanese relations than on the intrinsic merits of such an organisation.

CONCLUSION: The post World War II movement toward freer trade in manufactured goods has benefited much from GATT. However, as further progress has become more difficult to achieve, loopholes to GATT (such as Voluntary Export Restraints) have been exploited, and devices to outflank GATT (such as anti-dumping laws) have been invented. To overcome the stagnation in multi-lateral GATT-based negotiations, regional or bilateral free trade agreements have been advocated and implemented in recent free trade years. These regional blocs can be consistent with GATT provided (a) that they eliminate or substantially reduce trade barriers among members, and (b) that they achieve a rapid lowering of members' external tariffs to GATT-equivalent levels or lower. However, in view of the prevailing trading patterns in Asia (mainly exports of manufactured goods and commodities to the large, wealthy

consumer markets of the OECD and relatively little trade between the smaller Asian countries which have similar resource endowments), the incentives to create an Asian trade bloc are small unless Japan is included in such a group. The willingness of Japan to be included will in turn depend on the state of Japanese-US relations in the first instance, and possibly Japan-EC relations in the future. There is therefore a major obligation on the US and the EC to preserve the GATT-style open trading arrangements. If they do not, then they could well drive Japan to participate in the formation of an Asian trading bloc which economic analysis suggests the world would be better off without.

REGIONAL SURVEY

THE CHANGING STRUCTURE OF ASIAN EXPORT EXPOSURE

Trade remains either a major or the dominant component of GDP for the countries in the Asia-Pacific rim. During 1990, the value of trade involving the major East Asian economies (excluding Australasia) was over US\$1 trillion or 30% of total world trade (1). Japan alone accounted for 48% of this US\$1 trillion (Table 1 overleaf). With the exception of Japan and China which have huge domestic markets, and the Philippines which has failed to develop fully its export potential, the economies of the region have been mainly export driven over the 1980s. During the decade, large trade surpluses were built up by Taiwan, Korea, Malaysia and Indonesia while Hong Kong and Singapore remained active entrepôts. However, the maturation of the business cycles in the region has seen the trade account, and thus the contribution of net exports to GDP, turn negative in many countries, while growth has been driven by domestic demand. Nevertheless, product mix, comparatively low labour costs and the huge amounts of foreign direct investment (FDI), especially in South East Asia, imply that exports will again be the engine of growth during the next economic upswing. It is therefore necessary to examine the structure of Asian exports, both by destination and product, and to analyse how this structure has evolved over recent years, to determine the likely economic growth paths within the region.

The two major single markets for the region's exports are the US and Japan, accounting for 23% and 15% respectively of total exports during 1990, or alternatively 9% and 6% of GDP. However, exposure to these two markets varies widely throughout the region and consequently the economic health of both or either can have a disproportionate effect on an individual economy's growth path. It is not intended to give a detailed analysis of the state of the US and Japanese economies in this article -- the former is beyond the scope of this journal, the latter has been covered in the previous issue -- but a brief overview is required.

Over the next 6-12 months, the US economy can be expected to emerge slowly from recession while growth in Japan will likely slow and be negligible over 1 or 2 quarters. Turning to the US first, although there has been a clear step up in reserves since the beginning of the year (Chart 1), and despite substantial cuts in interest rates, the Fed has failed to lift the broader money aggregates (Chart 2). M3 is still growing at its lowest rate year-on-year for 20 years and has been flat since February, while M2 is growing towards the bottom end of the Fed's 2.5-6.5% target range. Lending has failed to respond to lower interest rates for a number of possible reasons. Firstly, the banks may be unwilling to lend. Secondly, and more plausibly, businesses and consumers may be unwilling to borrow as they are in the process of rebuilding their balance sheets. From the mid 1980s, private debt as a percentage of GNP rose from 100% to its current level of 129%, and many businesses and consumers are looking, if anything, to reduce their gearing. Finally, and perhaps as a consequence of this excess gearing, interest rates may not be low enough to encourage borrowing.

(1) Total world trade is taken to be the value of total world exports as calculated by the IMF (1990=US\$3.33 trillion). The IMF also gives a figure for total world trade (1990=US\$6.79 trillion) but this measures total flows and therefore involves double counting whereby exports from one country appear as imports from that country in other countries' trade statistics.

TABLE 1

Trade in Asia as a % of GDP (US\$ billion 1990)

	<u>Exports</u>	<u>% GDP</u>	<u>Imports</u>	<u>% GDP</u>	<u>Total Trade</u>	<u>% GDP</u>
Japan	280.4	9%	216.8	7%	497.2	16%
Hong Kong	82.3	118%	82.4	118%	164.7	236%
South Korea	65.0	27%	69.8	29%	134.8	56%
Taiwan	<u>66.5</u>	<u>43%</u>	<u>54.2</u>	<u>35%</u>	<u>120.7</u>	<u>78%</u>
North Asia	213.8	46%	206.4	45%	N/A	N/A
Singapore	54.6	167%	62.9	192%	117.5	359%
Malaysia	29.5	69%	29.3	69%	58.8	138%
Thailand	23.0	29%	32.9	41%	55.9	70%
Indonesia	26.7	27%	21.6	22%	48.3	49%
Philippines	<u>8.4</u>	<u>18%</u>	<u>12.2</u>	<u>26%</u>	<u>20.6</u>	<u>44%</u>
South Asia	142.2	47%	158.9	53%	N/A	N/A
China	62.1	19%	53.4	16%	115.5	35%
Total (Exc. Japan)	<u>418.1</u>	<u>38%</u>	<u>418.7</u>	<u>38%</u>	<u>534.9*</u>	<u>49%*</u>
Total	<u>698.5</u>	<u>16%</u>	<u>635.5</u>	<u>15%</u>	<u>1032.1*</u>	<u>24%*</u>

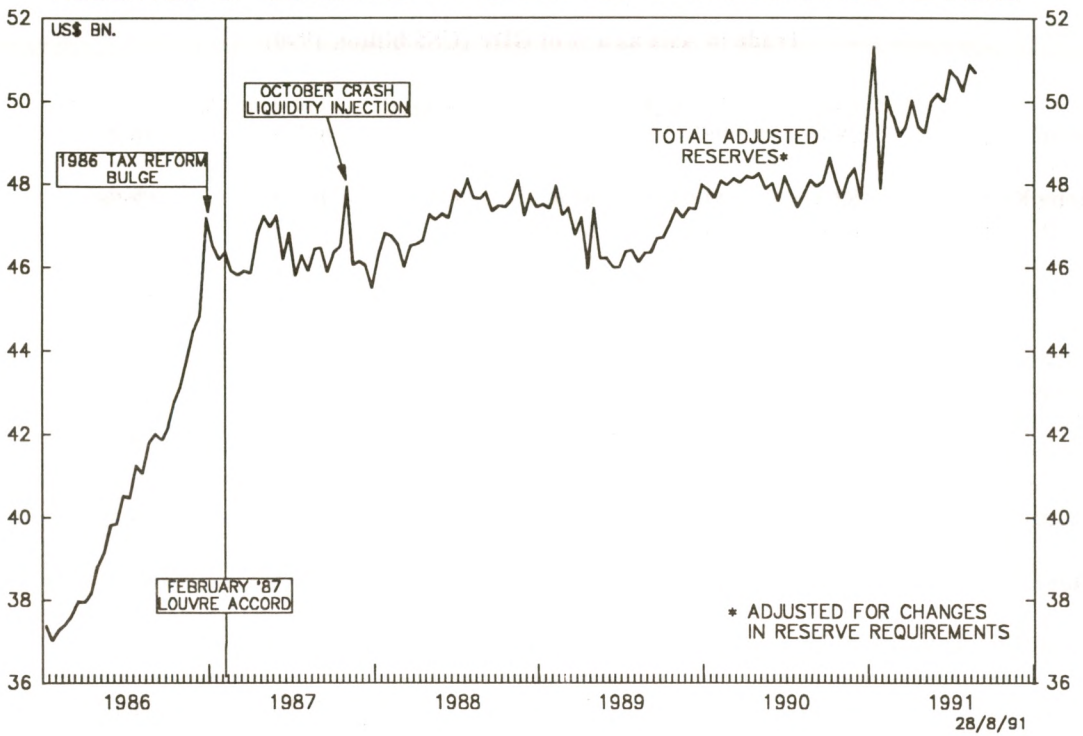
* Figures are adjusted to avoid double counting.

N/A Figures are not available.

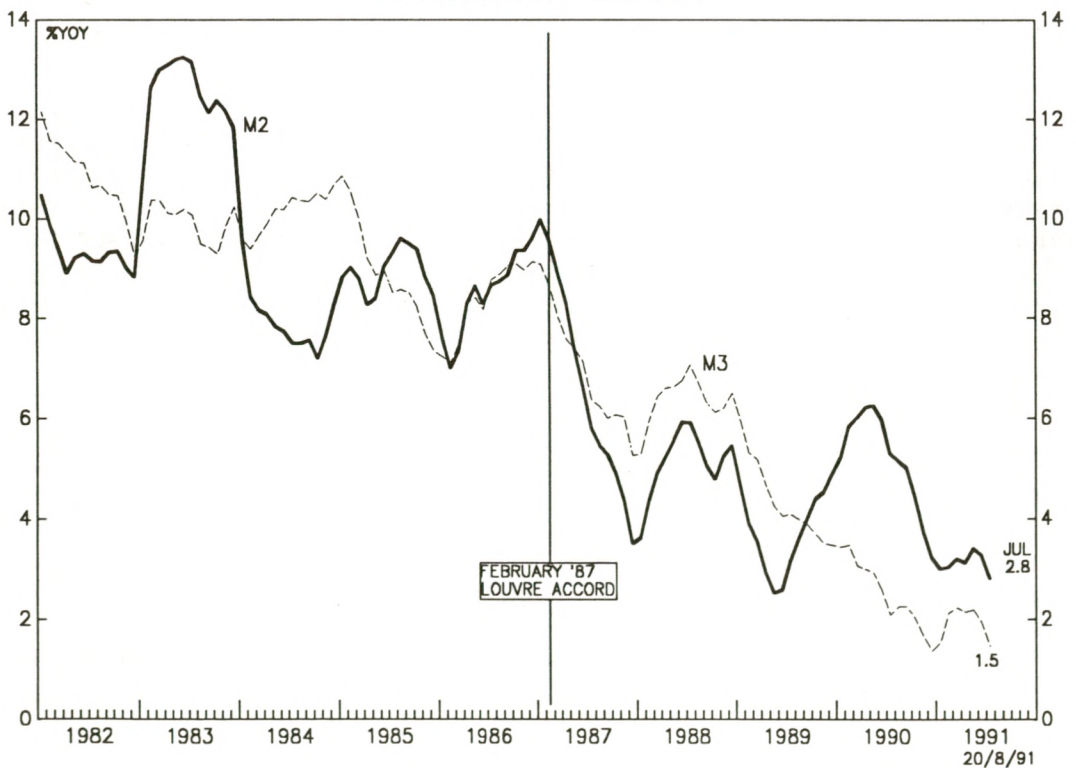
The chairman of the Fed, Alan Greenspan, is clearly anxious to reinforce the trend towards price stability and will not wish to reliquify the economy too quickly. This is demonstrated by his decision to retain the 1991 money growth targets into 1992. However, there is scope for faster broad money growth than at present without compromising inflation objectives, and this implies further cuts in interest rates with Fed funds falling towards 5%. Nevertheless, one cannot expect broad money growth to pick up substantially given the current trend in reserves, and without an acceleration in broad money, the economy will lack the fuel to stage a strong recovery.

Japan by contrast is only just starting to slow following four years of exceptional, and probably above potential economic growth. As outlined in the previous issue of AMM, both M2 + CDs and M3 + CDs have decelerated sharply since May 1990 (Chart 3) and the former is now growing at its lowest annual rate since records began. The Bank of Japan, in engineering a shortish but very sharp monetary squeeze to rid the economy of the liquidity overhang built up since the February 1987 Louvre Accord, has succeeded in controlling asset and goods price inflation in the economy, but the price will be 1 or 2 quarters of very slow growth. However, this adjustment should allow the economy to return to a non-inflationary potential growth path of around 4% per annum (Chart 4).

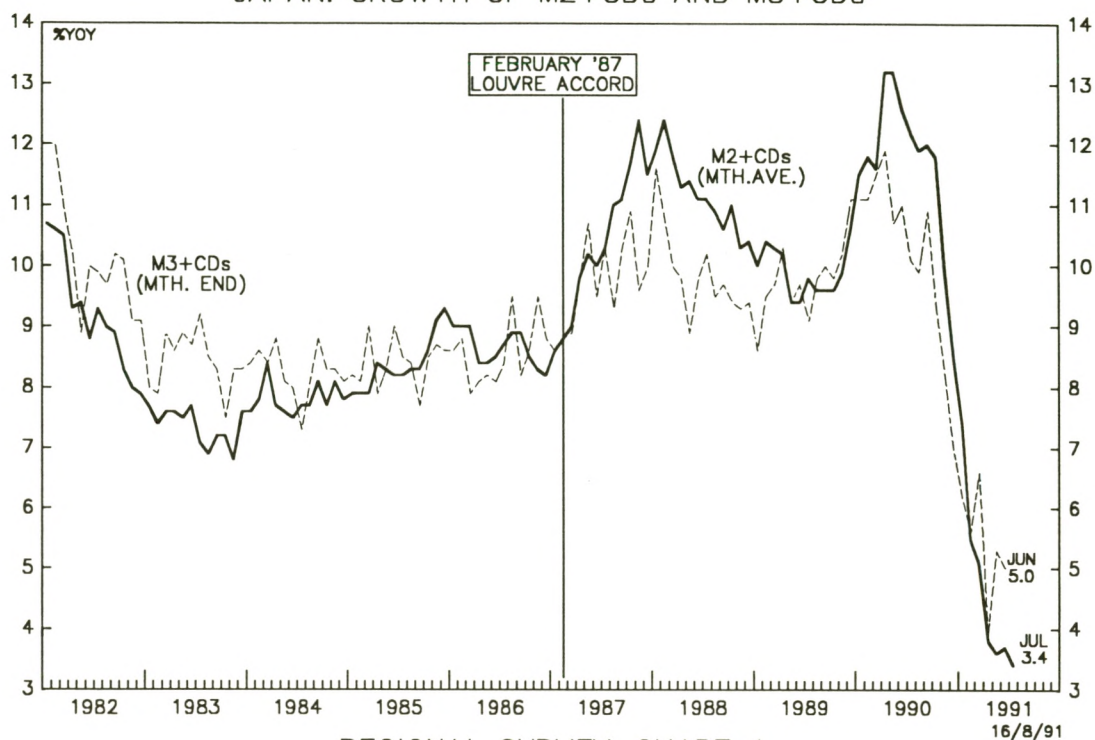
REGIONAL SURVEY: CHART 1
RESERVES OF US BANKS HAVE SHIFTED UPWARDS SINCE YEAREND



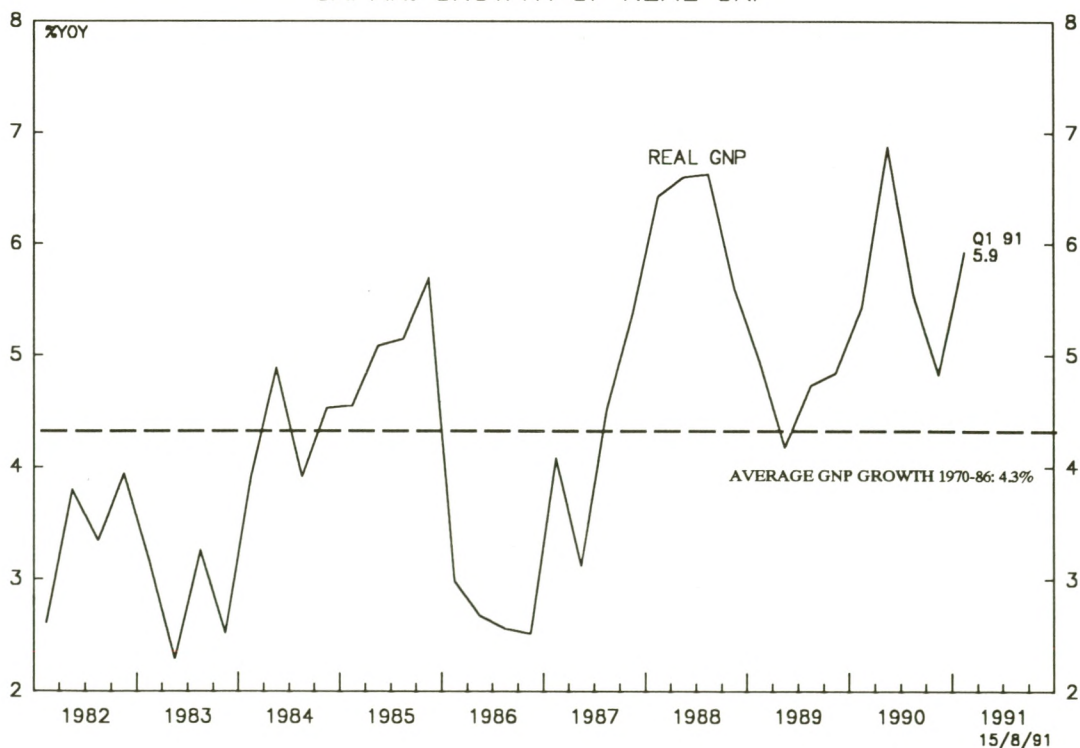
REGIONAL SURVEY: CHART 2
US MONETARY GROWTH



REGIONAL SURVEY: CHART 3
JAPAN: GROWTH OF M2+CDs AND M3+CDs



REGIONAL SURVEY: CHART 4
JAPAN: GROWTH OF REAL GNP



What then the implication of slow economic recovery in the US combined with a sharp slowdown in Japan for growth in the economies of the region? To answer this question it is necessary to undertake a more detailed analysis of regional export exposure.

TRENDS IN EXPORT DEPENDENCE

TABLE 2

Exports of Asian Economies as a % of GDP - 1985 and 1990

	<u>1985</u>	<u>1990</u>
Japan	11%	9%
Hong Kong	90%	118%
South Korea	34%	27%
Taiwan	<u>49%</u>	<u>43%</u>
North Asia	49%	46%
Singapore	129%	167%
Malaysia	49%	69%
Thailand	19%	29%
Indonesia	22%	27%
Philippines	<u>15%</u>	<u>18%</u>
South Asia	34%	47%
China	10%	19%
Total (Exc. Japan)	<u>28%</u>	<u>38%</u>
Total	<u>16%</u>	<u>16%</u>

The region as a whole, excluding Japan, has increased its dependence on exports from 28% of GDP in 1985 to 38% to GDP in 1990. However, three major trends are clear within these figures. The first trend shows that the share of exports in GDP has fallen in South Korea and Taiwan reflecting the maturation of their domestic manufacturing sectors, and their relative loss of export competitiveness as a result of rising internal costs of production and appreciating currencies. In this respect Korea and Taiwan are following the typical pattern of economic development already experienced by Japan during the 1960s and 1970s. As domestic production of manufactured goods has become more expensive, low technology production has been relocated overseas and the dependence on services and consumption has increased. However, both countries are investing heavily to upgrade their product lines, and the share of the export sector, although falling, remains significant.

The second trend to emerge is the increased share of exports from the entrepôts of Hong Kong and Singapore. Hong Kong's domestic export trade has fallen as a percentage of GDP, much in line with Korea and Taiwan, and for many of the same

reasons. The share of domestic exports in GDP has been reduced from 50% in 1985 to 41% in 1990. However, the share of re-exports in GDP has surged from 40% in 1985 to 76% in 1990, reflecting China's increased integration with the world economy, and the relocation of Hong Kong manufacturing to Southern China. In Singapore, by contrast, the ratio of domestic to total exports has remained little changed at around 2:3 over 1985-90, although the share of oil exports has fallen sharply from 49% to 35% of GDP. Nevertheless, Singapore is experiencing similar wage and currency pressures to its North East Asian counterparts and an increase in the importance of the re-export trade can be expected over the next few years. The growing integration of the Singaporean economy with Malaysia and Indonesia should accelerate this trend.

The third trend to emerge is the rapid growth of export dependency in the emerging economies of South East Asia and China. The export trade of these countries is benefiting substantially from gains in competitiveness vis-a-vis the North East Asian economies, and policies promoting rapid deregulation and industrialisation.

DEPENDENCE ON EXPORTS TO THE US

TABLE 3

Asian Exports to the US as a % of Total Exports - 1985 and 1990

		<u>1985</u>	<u>1990</u>
Japan		37%	32%
Hong Kong:	Domestic Exports	44%	29%
	Re-Exports	14%	21%
	Total Exports	31%	24%
South Korea		36%	30%
Taiwan		48%	32%
Singapore:	Domestic Exports	25%	27%
	Re-Exports	14%	11%
	Total Exports	21%	21%
Malaysia		13%	17%
Thailand		20%	23%
Indonesia		21%	13%
Philippines		35%	37%
China:	Direct Exports	9%	8%
	Direct Exports + Exports via HK	14%	25%

Table 3 shows that Japan and the North East Asian economies have successfully reduced their dependence on the US market since 1985. Nevertheless, their exposure remains significant and they remain highly geared to a pick-up in US demand, however weak. The picture in South East Asia is more mixed. The US exposure of Singapore, Malaysia, Thailand and the Philippines is little changed over the period as is China's direct exposure, although China's exports via Hong Kong have surged over the last 5 years. Indonesia, by contrast, has seen its US exposure fall dramatically.

DEPENDENCE ON EXPORTS TO JAPAN

TABLE 4

Asian Exports to Japan as a % of Total Exports - 1985 and 1990

		<u>1985</u>	<u>1990</u>
Hong Kong:	Domestic Exports	4%	5%
	Re-Exports	6%	6%
	Total Exports	4%	6%
South Korea		15%	19%
Taiwan		11%	12%
Singapore:	Domestic Exports	12%	10%
	Re-Exports	5%	6%
	Total Exports	9%	9%
Malaysia		24%	15%
Thailand		13%	17%
Indonesia		45%	43%
Philippines		19%	20%
China:	Direct Exports	22%	15%
	Direct Exports +		
	Exports via HK	24%	18%

There has been little significant change in the region's exposure to Japan over the last 5 years although in general this exposure has diminished slightly. With the exception of Indonesia which is heavily dependent on Japanese exports, and Hong Kong which has minimal exposure, regional economies tend to sell in excess of 10% of their exports to Japan. However, this exposure is generally lower than exposure to the US. Incidentally, all the countries in the region except Indonesia and China run significant trade deficits with Japan. The aggregate deficit in 1990 was US\$32 billion or 5% of regional GDP.

THE IMPORTANCE OF INTRA-REGIONAL EXPORTS

TABLE 5

Exports within the Asian Region (Excluding Japan) as a % of Total Exports - 1985 and 1990

		<u>1985</u>	<u>1990</u>
Hong Kong:	Exports to China	26%	25%
	Exports to all Asia	35%	41%
South Korea		12%	17%
Taiwan		15%	26%
Singapore:	Exports to Malaysia	16%	13%
	Exports to all Asia	44%	44%
Malaysia:	Exports to Singapore	19%	23%
	Exports to all Asia	42%	46%
Thailand		29%	22%
Indonesia		20%	28%
Philippines		19%	17%
China:	Direct Exports to HK	26%	43%
	Direct Exports to all Asia	47%	57%
	Direct Exports +		
	Exports via HK	35%	18%

Although Japan remains an important market for regional exports, of greater importance is the market for exports within the region. The relocation of Korean and Taiwanese production to lower cost centres in South East Asia has been accompanied by a surge in exports of capital goods to these countries. This has raised considerably their share of intra-regional exports in total exports. Hong Kong and Singapore, in their capacity of regional entrepôts, already have a high exposure to other Asian markets which has remained reasonably stable over recent years, while Malaysia with its close links to Singapore also maintains a high Asian export exposure. China by contrast has seen its Asian exposure halve over recent years if one uses the most complete measure of direct exports to Asia plus re-exports to Asia via Hong Kong. However, this reflects the ultra rapid growth of re-exports via Hong Kong to the US which have quadrupled since 1985 from a very low base, rather than a slowdown in the growth of exports to Asia -- these have merely doubled! Nevertheless, a major distortion remains in the China figures -- the omission of China/Taiwan trade. Hong Kong statistics report re-exports via Hong Kong of US\$765 from China to Taiwan in 1990 and US\$3,278 from Taiwan to China, but it seems likely that these figures understate substantially the true value of trade.

THE EMERGENCE OF EUROPEAN EXPORTS

TABLE 6

Asian Exports to Western Europe as a % of Total Exports - 1985 and 1990

		<u>1985</u>	<u>1990</u>
Hong Kong:	Domestic Exports	22%	24%
	Re-Exports	6%	18%
	Total Exports	15%	20%
South Korea		12%	16%
Taiwan		9%	16%
Singapore:	Domestic Exports	12%	16%
	Re-Exports	11%	19%
	Total Exports	12%	17%
Malaysia		15%	15%
Thailand		19%	21%
Indonesia		6%	12%
Philippines		17%	18%
China:	Direct Exports	9%	10%
	Direct Exports +		
	Export via HK	10%	18%

Almost all the countries in the region have managed to increase their share of exports to Western Europe over recent years to the extent that in many cases the exposure now exceeds the exposure to Japan. The flexibility of Asian production processes has also enabled the region to react swiftly to the opportunities presented by an opening Eastern Europe and USSR, although at the present time the value of this trade is negligible relative to total.

TABLE 7

Growth of Asian Exports 1989-1990

		<u>US</u>	<u>Japan</u>	<u>Asia</u>	<u>W. Europe</u>	<u>Total</u>
Hong Kong:	Domestic Exports	-8%	-7%	13%	3%	1%
	Re-Exports	22%	10%	11%	54%	20%
	Total Exports	7%	3%	11%	27%	13%
South Korea		-6%	-6%	23%	46%	4%
Taiwan		-11%	-10%	24%	9%	0%
Singapore:	Domestic Exports	13%	25%	30%	23%	27%
	Re-Exports	6%	24%	17%	53%	14%
	Total Exports	12%	25%	23%	33%	22%
Malaysia		6%	12%	32%	20%	17%
Thailand		20%	15%	6%	28%	14%
Indonesia		2%	22%	26%	32%	18%
Philippines		4%	6%	10%	10%	5%
China:	Direct Exports	18%	8%	23%	11%	18%
	Direct Exports +					
	Exports via HK	22%	8%	24%	28%	18%

The reunification of Germany spurred the exceptional growth in exports to Europe over 1990 (Table 7) and in many cases Europe was the market that saw the greatest growth. Nevertheless, this is probably a one-off phenomenon as the surge in East German consumption is unlikely to be repeated. More significant was the continued strength of intra-regional export growth which remained robust in the face of a general deceleration in the growth of exports to the US, and to a lesser extent Japan.

THE DIMINISHING IMPORTANCE OF COMMODITY EXPORTS

TABLE 8

Commodity and Manufacturing Exports as a % of Total Asian Exports - 1985 and 1990

		<u>1985</u>	<u>1990</u>
Malaysia:	Oil & Gas Exports	30%	16%
	Non-Oil & Gas Export	38%	25%
	Total Commodity Exports	68%	41%
	Manufacturing Exports	32%	59%
Thailand:	Commodity Exports	51%	25%
	Manufacturing Exports	49%	75%
Indonesia:	Oil & Gas Exports	66%	45%
	Non-Oil & Gas Exports	25%	29%
	Total Commodity Exports	91%	74%
	Manufacturing Exports	9%	26%
China:	Oil & Gas Exports	51%	14%
	Non-Oil & Gas Exports	20%	12%
	Total Commodity Exports	71%	26%
	Manufacturing Exports	49%	74%

Apart from changes in the geographical breakdown in the region's exports, there has also been a marked change in the composition of these exports which in turn partly explains these geographical shifts. The four major commodity exporters of the region -- Malaysia, Thailand, Indonesia and China -- have been remarkably successful in reducing their dependence on commodity exports over recent years. At the same time, aided by huge flows of FDI from Japan and the NICs, they have boosted significantly their manufacturing capabilities. The value of manufacturing exports in US\$ terms over 1985-90 increased 3.5 times in Malaysia and China, 4 times in Indonesia and 5 times in Thailand, while the value of commodity exports remained virtually constant. Certainly given the continuing flows of FDI into South East Asia and China, this trend towards industrialisation will likely continue apace and this has implications for the future geographical dependency of the region. As indicated previously, regional exposure to the Japanese market has fallen slightly in recent years but tends to remain highest among the commodity producing countries, Korea aside. However, it is revealing to examine the geographical exposure of manufacturing exports. Unfortunately a breakdown of exports by product and by destination is unavailable from Thailand and China but Malaysia and Indonesia publish superior statistics. Manufacturing exports from Malaysia to Japan in 1990 accounted for only 8% of total manufacturing exports (compared to 15% of total exports) while 25% were to the US and almost 50% were within the region. Similar figures for Indonesia show that only 22% of non-oil and gas exports were destined for Japan (compared to 43% of total

exports) during 1990 while 16% were to the US and 36% were within the region. It is likely that the figures for purely manufacturing exports, if available, would show a further reduced dependence on Japan. The implication of the above is that although Japan will likely remain a huge importer of commodities, in relative terms the importance of commodity exports to the region should continue to diminish, and with it the region's dependence on the Japanese market.

SUMMARY AND FORECAST: The structure of Asian export exposure has shifted dramatically over the 1980s but the US and Japan remain the two largest single markets for regional exports and therefore, their growth paths will continue to have a disproportionate influence on regional export performance and thus economic growth. Over the next 6-12 months one can expect the US to emerge sluggishly from recession while growth in Japan will likely slow and be negligible over 1 or 2 quarters. This combination implies that the export performance of the North East Asian economies will be superior to that of the South East Asian commodity exporters. However, export growth is unlikely to collapse due to the increased importance of intra-regional trade. This should remain relatively buoyant as any slowdown in South East Asia is unlikely to be severe, and flows of FDI remain strong.

Longer term, North East Asia's dependency on the US market should diminish further although the US will remain the region's principle single market. At the same time, manufacturing exports in South East Asia should continue to grow relative to commodity exports implying further falls in relative exposure to the Japanese market. The exceptional growth in exports to Western Europe seen in 1990 is unlikely to be repeated, although the flexibility of Asian production should allow the region to respond quickly to incremental demands from Indo-China, the Soviet Union and Eastern Europe. However, the growth of intra-regional exports will continue to outstrip growth to other destinations in line with the rate of industrialisation of the region relative to the world.

HONG KONG THE DYNAMICS AND SIGNIFICANCE OF THE RE-EXPORT TRADE WITH THE PRC

Introduction

China is now one of the most important trading partners of Hong Kong. In terms of total trade flows, i.e. imports plus total exports, China is now even more important than the United States (Chart 1).

The rapid development of the Hong Kong-China trade has been the direct outcome of the open door policy pursued by the PRC since 1979. This has led to Hong Kong being used as the key gateway for China's trade with the world, given the absence of major deep water ports in southern China. Furthermore the continuous relocation of Hong Kong's manufacturing base to the Guangdong Province generated an increasingly important re-export trade.

The aim of this article is to quantify the significance to Hong Kong of the re-export trade with China, and to explore in some detail certain aspects of this trade relating to the manufacturing activities by Hong Kong entities in China.

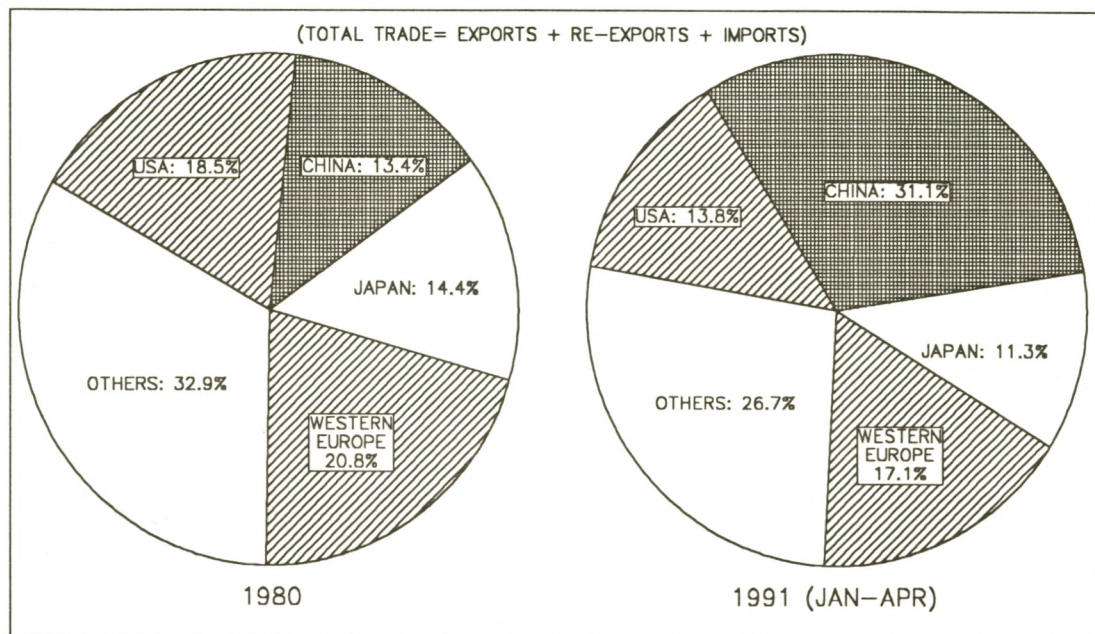
The significance of the re-export trade to Hong Kong rests on two factors. Firstly, since 1988 re-exports have overtaken domestic exports in the total export trade, accounting in 1990 for 64.6% of the total (Chart 2). Re-exports to and from China have also risen rapidly (Chart 3). In 1990 re-exports from China accounted for 58% and re-exports to China for 26.7% of total re-exports. These two percentages cannot be added together as the trade statistics give figures for total re-exports and then differentiate country of origin and country of destination. These figures, however, indicate clearly that China is the single most important country in this, the fastest growing component, of Hong Kong's trade (Chart 4).

Secondly, in the last five years or so another aspect of the re-export trade flows with China has acquired significance. This is the part of re-exports to and imports from China which are connected with "outward processing activities". The definition used by the Hong Kong Census and Statistics Department for "outward processing" is the following:

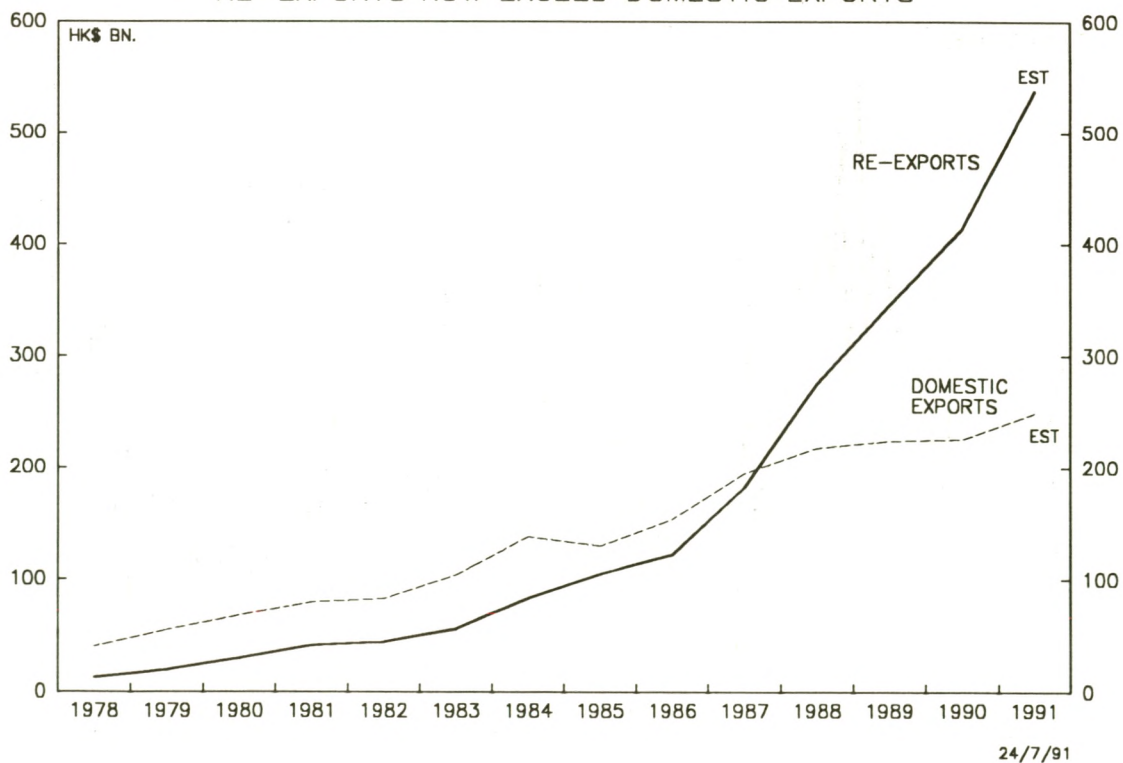
"Exports to China for outward processing refer to the exportation of raw materials and semi-manufactures (including near-finished goods) from or through Hong Kong to China for processing (including partial assembling, packaging etc) with a contractual arrangement for subsequent re-importation of the processed goods into Hong Kong."

"Imports from China related to outward processing refer to the importation of goods from China of which all or part of their raw materials or semi-manufactures (including near-finished goods) are under contractual arrangement exported from or through Hong Kong to China for processing (including partial assembling, packaging etc)."

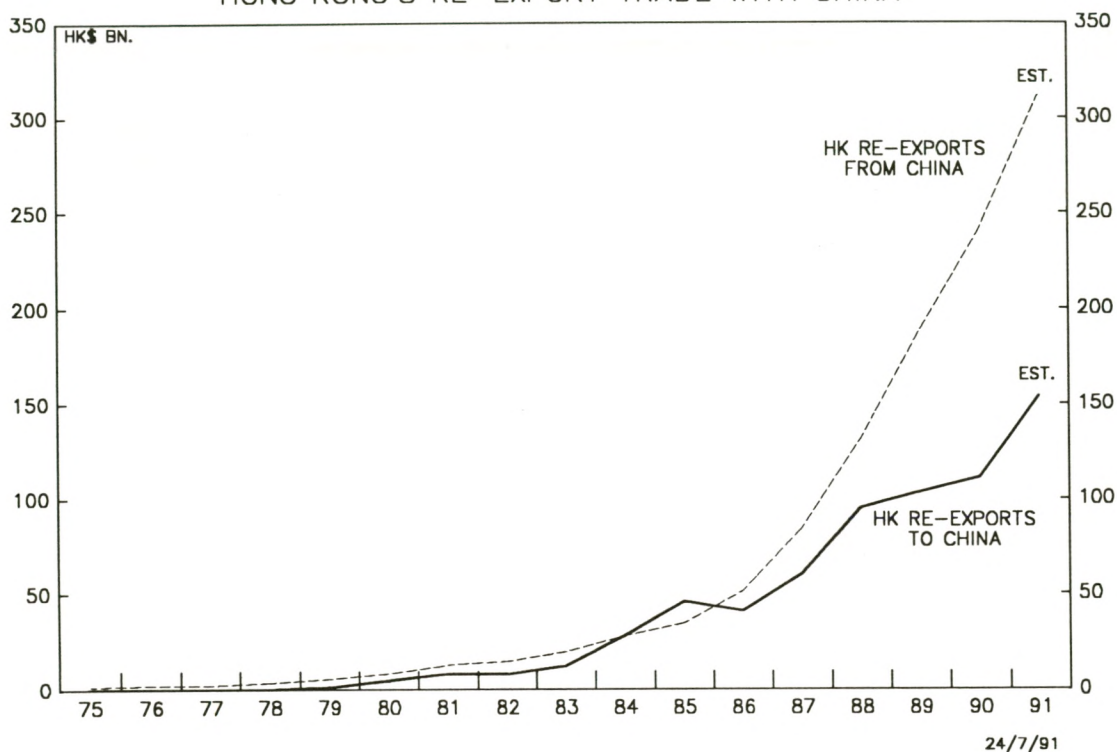
HONG KONG: CHART 1
COMPONENT SHARES OF HONG KONG'S TOTAL TRADE



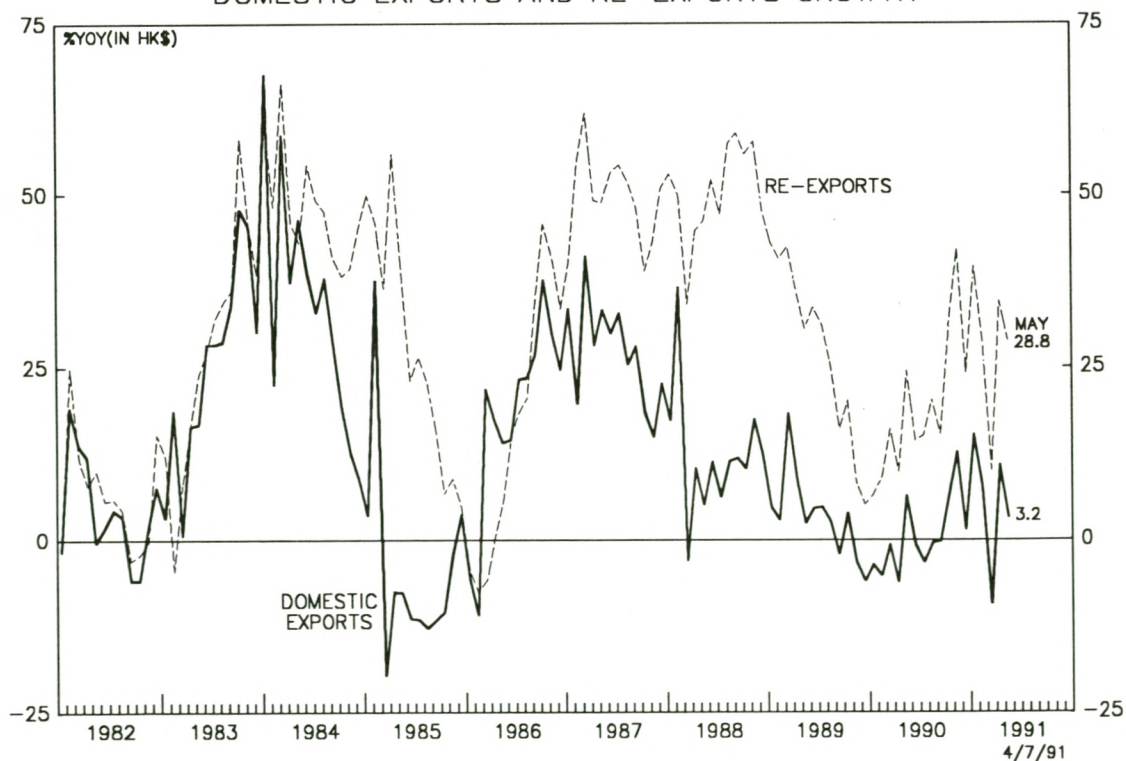
HONG KONG: CHART 2
RE-EXPORTS NOW EXCEED DOMESTIC EXPORTS



HONG KONG: CHART 3
HONG KONG'S RE-EXPORT TRADE WITH CHINA



HONG KONG: CHART 4
DOMESTIC EXPORTS AND RE-EXPORTS GROWTH



It is important to note that these definitions involve flows of goods which are most likely to end up as further re-exports, although a portion of them will be consumed either in China or in Hong Kong. There are, however, strictly enforced controls to ensure that Hong Kong's country of origin rules are complied with.

The importance of "outward processing" activities for Hong Kong are self-evident as they represent the most visible aspect of the relocation of the Territory's manufacturing base to China in general and Guangdong province in particular. Outward processing related re-exports now dominate the trade with China, covering both imports from and domestic and re-exports to the PRC. Table 1 shows the relevant statistics starting from 1988 when the first official surveys were undertaken.

TABLE 1

The Value of "Outward Processing" (OP) Related Trade, 1988-1990, HKD bn.

	1988		1989		1990	
	Value	% OP	Value	% OP	Value	% OP
1. Imports from China	49.96	N/A (*)	195.39	58.1	234.70	61.8
2. Total Exports to China	40.50	46.0	145.05	53.0	156.42	58.8
(a) Domestic	10.87	72.9	42.08	76.0	46.10	79.0
(b) Re-exports	29.62	36.2	102.97	43.6	110.31	50.3

NB: The values are the total values of imports, exports etc. from and to China. To calculate the actual value of the outward processing related flows multiply the (% OP) figure with that of the corresponding total. Figures for 1988 cover Oct.-Dec. only.

(*) On the basis of the growth rates for 1989-90 this can be approximated at 54.6%.

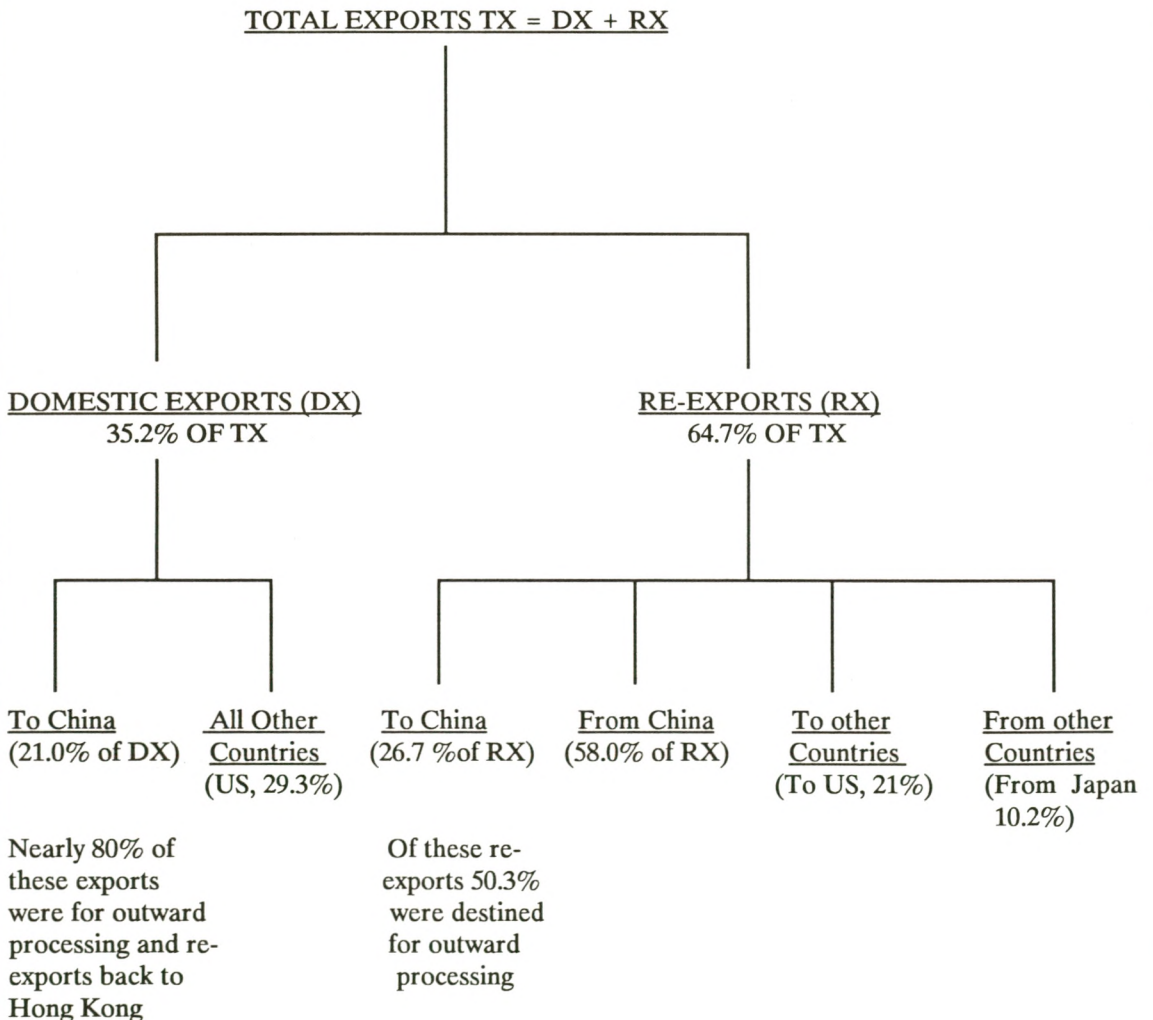
Source: Hong Kong External Trade, March 1989, 1990 and 1991. Some of the figures have been since revised, but the important estimates here are the (% OP) which are based on the samples taken. All figures, percentages etc. are rounded.

The overall picture of Hong Kong's trade is quite complicated given the separate definitions of imports, domestic exports and re-exports to and from different countries (further broken down in the case of PRC into outward processing activities and others).

The following tree chart summarises the export flows in 1990 and indicates their quantitative importance.

TREE CHART

Hong Kong's Export Trade Flows, 1990, Percentage of totals



The Value Added of Re-exports

Any production or service-related activity undertaken in Hong Kong generates wages, salaries and profits and this adds to Hong Kong's GDP. It would now follow that if any of export-related activity was to take place outside Hong Kong there would be a "loss" of value added to Hong Kong. The world "loss" is used here with a degree of caution because, as it will be presently shown, there are also potential gains involved.

Table 2 shows a hypothetical example of the way that export activities generate value added for Hong Kong. The Table uses some ideas outlined in the Economic Report, Hongkong Bank, January 1991.

TABLE 2

Value Added and Export Trade
(Figures in HKD, all hypothetical)

1.	Value of imported goods (raw materials etc)	100
2.	Processing of these imports to produce exports: Value added in terms of wages plus profits	50
3.	Exports	150
4.	Value added to Hong Kong's GDP (equivalent to the trade surplus of 50)	50

Table 3 shows the more complex case of exports involving outward processing activities.

TABLE 3

Value Added and Re-export Trade
(Figures in HKD, all hypothetical)

1.	Value of imported goods (raw materials etc)	100
2.	Processing these imports to produce exports: Value added in terms of wages plus profits	50
3.	Export to China for outward processing:	150
4.	In China these goods are further processed adding another 50 of wages and profits: Value added in China	50
5.	Imports from China related to outward processing	200
6.	Further processing of these imports in Hong Kong: Value added in terms of wages on profits	50
7.	Exports of these goods	250
8.	Value added to Hong Kong's GDP (equivalent to the trade surplus of 100)	100
9.	Value added "lost" to Hong Kong is the HKD 50 of wages on profits generated in China, or equivalently item (5) minus (3).	

Since 1988 Q4 there is statistical information in Hong Kong which allows the calculation of this "lost" outward processing-related value added. Table 4 outlines the results and expresses them as a percentage of GDP.

TABLE 4

An estimate of the value added relating to outward processing trade (OP), HKD bn

	Imports from China <u>Minus</u> related to OP	Exports to China related to OP	Difference (D)	D as % of GDP
1988	27.27(*)	18.64	8.63	7.9
1989	113.58	76.86	36.72	7.4
1990	145.10	91.91	53.19	9.7
			Average	8.3

NB: The last column shows the value-added generated in China and hence "lost" to Hong Kong as a percentage of Hong Kong's GDP. Since the data for 1988 cover Oct.-Dec. only, the GDP figures for 1988 were reduced by 75%. There are some differences between these figures and those of Table 3 caused by rounding.

(*) Estimate

An average 8.3% of GDP "lost" to China appears to be a substantial figure but there are a large number of reasons why these figures might not be accurate and are likely to overestimate the "loss". Furthermore outward processing of re-exports may well offer sufficient benefits to Hong Kong to outweigh any losses.

The Economic Impact of Re-exports

The values in Table 4 are potentially distorted by a number of factors. Firstly, imports from China are recorded c.i.f. (cost, insurance and freight) but exports to China are recorded f.o.b. (free on board). This means that imports are relatively overvalued in relation to exports thus causing the difference between the two to widen. Secondly, imports from China classified under outward processing definitions may not contain exclusively semi-manufactures etc. supplied from Hong Kong. If this misclassification is widespread then the basis of the definition of outward processing changes. If the base includes any imports from China then it would overstate the value of these outward processing-related imports. Thirdly, goods exported to China for eventual re-importation to Hong Kong may not in fact return because of changes in the contracts involved or changes in circumstances which make their re-importation unprofitable or even impossible. If this was to occur on a widespread basis, the value of these exports would be overstated. Finally, there is the problem of the lag between exports to and re-imports from China which may introduce nonseasonal fluctuations, although these would not affect the aggregate values over a longer time period.

There are also various reasons why the word "lost" value added is potentially misleading.

Firstly, taking the hypothetical value of item 5 in Table 3, the value added of HKD50 in China is assumed to remain in China. Although a very substantial proportion of the HKD50 will be wages and thus will remain and will be spent in China, a percentage of it will be profits accruing to the Hong Kong owners or partners of the Chinese venture which processed these goods. There are at present no systematic estimates for the part of the value added which is remitted back to Hong Kong. As the official statistics of the current account do not cover profits, interest and other factor returns then these sums can only be guessed at. One approach is to use as an approximation the 15% margin on re-exports used by the Statistics and Census Department when adjusting re-exports in general in order to calculate retained imports. This, however, is just a guess which will decrease the column marked (D) in Table 4 by 15% thus adjusting proportionately the percentage figures for the GDP "lost".

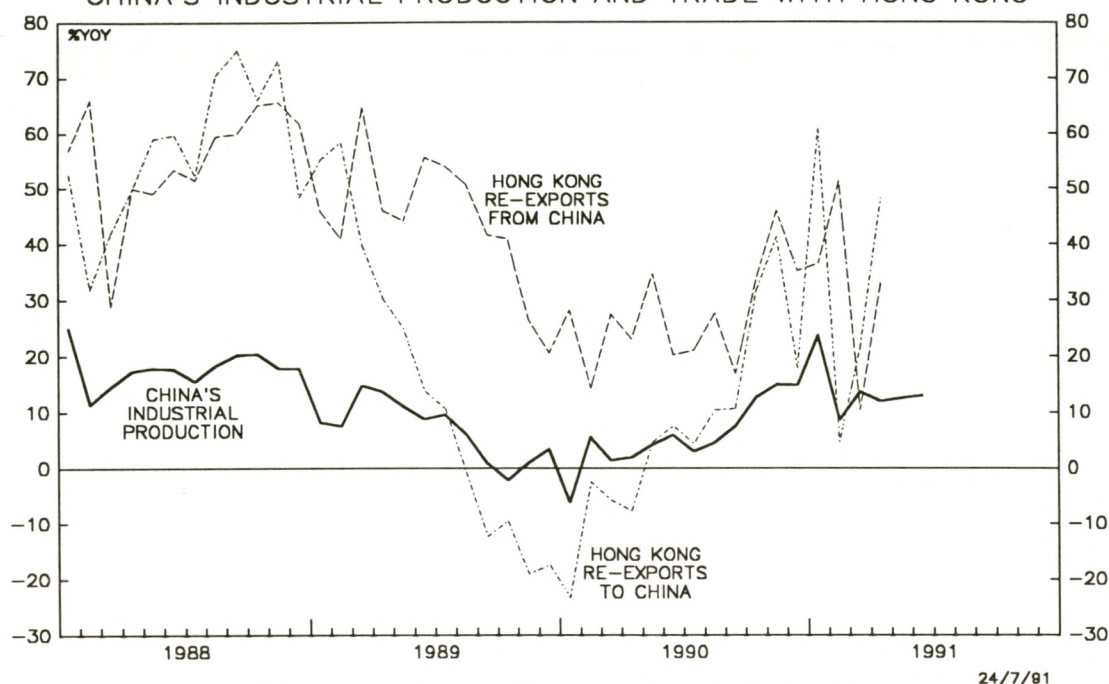
Secondly, there is anecdotal evidence that quite a substantial amount of this value added in China finds its way back to Hong Kong in the form of deposits with local banks. This is achieved through undercharging for the exports sent to China from Hong Kong and overcharging for imports received from China in Hong Kong. Again there is no way that this can be accurately assessed or calculated, if at all.

Thirdly, the relocation of manufacturing activities to China may cause Hong Kong to lose value added but may also result in substantial direct and indirect gains. For a start the relocation of manufacturing activities to China in general and Guangdong province in particular reduces wages and rent costs. This enables Hong Kong based exporters to compete more effectively and potentially increases the volume of their overseas sales. Although value added is now shared with China, the percentage increase in the volume of exports may more than compensate in terms of the Hong Kong value added portion of any "losses to China". If relocation of production was unprofitable or impossible then international competition could have eliminated the firms concerned thus reducing the Hong Kong portion of value added to zero.

Increasing manufacturing production and industrial activities in southern China leads to a multiple expansion of income in the areas concerned. Since nearly 95% of the outward processing is done in the Guangdong Province, the increase in local incomes leads to increased expenditures including those on imports from Hong Kong just across the border. (It has to be added that these imports could also be illegal as witnessed by the booming contraband trade between Hong Kong and southern China.)

Finally, the outward processing export-import flows must be appraised against the structural changes taking place at present in Hong Kong's economy. The share of manufacturing to Hong Kong's GDP has fallen from 22.2% in 1980 to 17.5% in 1989, with employment in industry having declined in 1990 by 160,000 workers from the peak achieved towards the end of 1987. The service sector has risen in importance particularly in the area related to imports and exports. Between 1980 and 1988 substantial gains were made in this particular area in terms of growth of employment and above average share of value added per employee compared to other service sectors. Furthermore the service sector in Hong Kong continues to exhibit higher productivity in relation to that of manufacturing. In 1989 the industrial sector in Hong Kong employed 29% of the labour force and produced about 18% of output whereas the service sector employed 50% of the labour force but produced 67.5% of the GDP.

HONG KONG: CHART 5
CHINA'S INDUSTRIAL PRODUCTION AND TRADE WITH HONG KONG



The growth of outward processing related trade is therefore but a cause and a symptom of Hong Kong's continuous shift towards a service based economy.

Business cycle considerations

The declining trend in the growth of domestic exports since the first quarter of 1989 shown in Chart 4 reflected primarily the effects of recession in the United States. The recovery in the rate of growth of re-exports which started in 1989 Q4 coincides with the recovery in the Chinese economy as shown in Chart 5. There is, however, an important long term development at work here. The percentage of re-exports to China which are destined for outward processing has been steadily rising from 36.2% in 1988 to 50.3% in 1990 (see Table 1). There is a similar trend on imports from China of which in 1990 nearly 62% were related to outward processing and hence were likely to be destined for re-export via Hong Kong. Although there are no specific figures or detailed information concerning the origin of re-exports from China if imports from China are any guide, then a significant percentage of these re-exports will contain "outward processing" components and hence will also be destined for overseas markets. It must now follow that Hong Kong's re-export trade with China will progressively reflect the movements of China's trade with the rest of the world rather than China's GDP movements. The consequences of this are very significant for a number of reasons.

Firstly, Hong Kong has benefited from China's early recovery during 1990-91 as the boost to the domestic and re-export trade coincided with the continuing recession in the United States. China trade in all its forms provided a countercyclical cushion for Hong Kong's economy. If the pattern outlined above in outward processing trade continues, then the cycles of the Chinese economy will be of less significance in influencing this part of Hong Kong's re-export trade. In other words, any countercy-

clical protection offered by out-of-phase movements of the Chinese economy in relation to the world economy will become of less importance. This conclusion, however, must be modified by the extent to which the re-export trade reflects demand for domestic uses and consumption in China and hence reflects the cyclical movements of that economy. Furthermore the imposition of tough credit and foreign exchange controls, which was a characteristic of the counterinflationary policies in China during 1988-89, simply stopped Chinese enterprises from using their Hong Kong connections to produce for export. In other words the current resurgence in the re-export trade reflects not only growing demand for Chinese and Hong Kong produced goods, but also the ability of Chinese enterprises and Hong Kong joint ventures to supply them. The current discussion concerning the impact on Hong Kong of China's MFN status with the USA has, therefore, to be appraised in this particular context. (See the relevant Economic Capsule in this issue of AMM pp.)

Secondly, since a significant proportion of the import and export trade with China is now outward processing related it tends to boost the overall value of Hong Kong's trade with China. This trade, however, as indicated above is progressively related to world demand for Chinese and Hong Kong produced goods rather than to China's GDP. Statistics which show the percentage of Hong Kong's trade with China unadjusted for the outward processing component result in an overweight position of China compared, say, that of the United States.

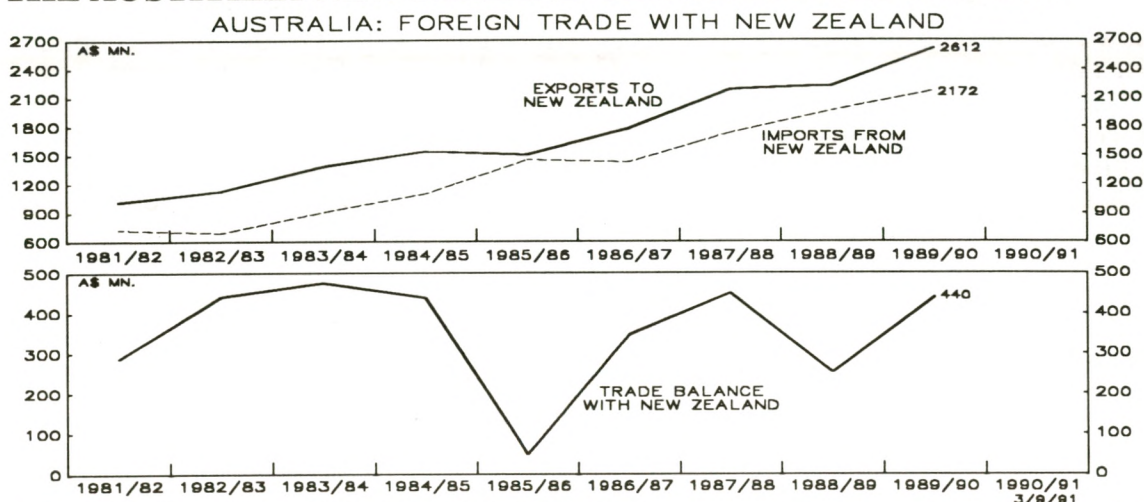
The Hongkong Bank Economic Report for January 1991 produced adjusted and unadjusted figures for Hong Kong's relative trade dependence on various countries, including China, by subtracting the part related to outward processing. A sample of the results is shown in Table 5.

TABLE 5			
Share of Hong Kong total exports (% of total)			
	1979	1989	
		Adjusted	Unadjusted
China	2.5	13.9	25.5
USA	27.4	29.2	25.3

The very small share of China in 1979 reflects the beginning of the open door policy introduced during that year. The 1989 unadjusted figures show China ahead of the US in terms of relative importance, a position sharply reversed when the adjustment indicated above is made.

FORECAST: The growth of re-export trade with China and the related outward processing component is another aspect of Hong Kong's changing economic structure. Although accurate quantative evidence is hard to come by, it would appear that, on balance, Hong Kong has benefited and will continue to benefit from the outward processing activities. The cyclical movements of Hong Kong's re-export trade will be progressively connected to the world business cycle rather than to movements in the Chinese economy and GDP.

THE AUSTRALIA-NEW ZEALAND CER TRADE AGREEMENT

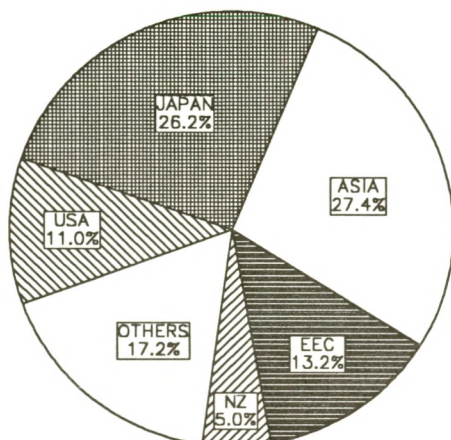


The Closer Economic Relations (CER) Trade Agreement that came into effect on 1st January 1983 is formally recognised by GATT as a "free trade area" agreement. It replaced and expanded the coverage of the New Zealand-Australia Free Trade Agreement (NAFTA) in place since 1st January 1966 which had been restricted to forestry products and a limited range of manufactured goods. The objectives of the CER Agreement, as stated in Article 1, are: (1) to strengthen the broader relationship between Australia and New Zealand; (2) to develop closer economic relations between the Member States through a mutually beneficial expansion of free trade between Australia and New Zealand; (3) to eliminate barriers to trade between Australia and New Zealand under an agreed timetable and with a minimum of disruption; and (4) to develop trade between New Zealand and Australia under conditions of fair competition.

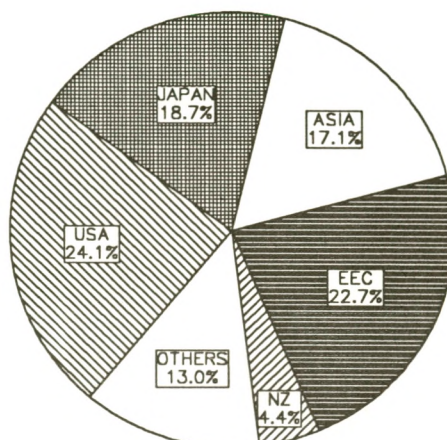
These objectives are praiseworthy indeed but is there any evidence that the Agreement has brought any tangible benefits and has boosted intra-Australian trade? Certainly trade has increased significantly in absolute terms. New Zealand exports to Australia grew 15 times between the signing of the NAFTA and CER agreements and have trebled again since. Similarly, Australian exports to New Zealand grew 10 times between 1966 and 1983 and have since doubled. However, in terms of relative performance gains have been less impressive. New Zealand has been the greater beneficiary -- the share of exports to Australia in total exports has risen from 12% in 1983 to 20%. Australia, by contrast, has seen its share of exports to New Zealand in total exports remain unchanged at 5% over the same period. This suggests that the CER Agreement has done little to boost trade performance but that gains are mostly due to the general expansion in world trade.

Nevertheless, aside from the problem of trade diversion discussed in the first article of this journal, the CER Agreement has probably benefited both countries by encouraging closer economic ties. Furthermore, it has not resulted in higher external tariffs although progress is lowering these tariffs remains painfully slow. The CER Agreement is being reviewed over this year and next and may be extended to cover trade in services as well as capital flows. Other areas being reviewed include shipping, standards, customs and quarantine, and competition policy. Any such extensions are to be welcomed assuming they do not create excessive trade diversion or harm trade with third parties.

AUSTRALIA: FOREIGN TRADE 1990



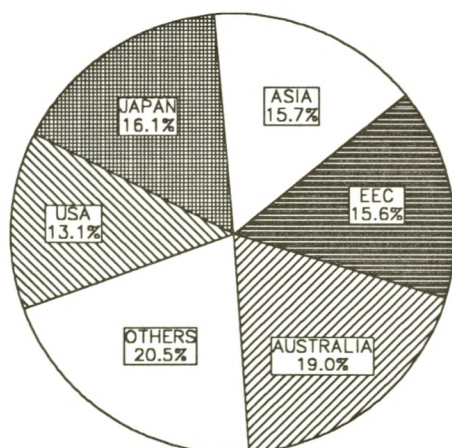
EXPORTS BY COUNTRY OF DESTINATION



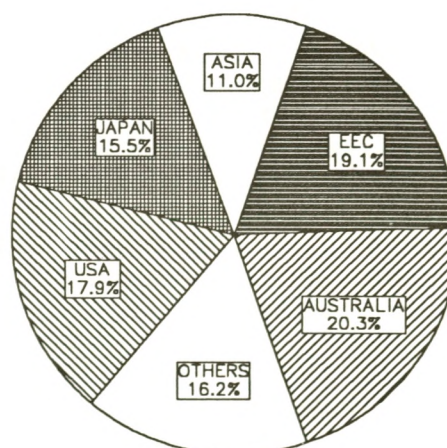
IMPORTS BY COUNTRY OF ORIGIN

4/9/91

NEW ZEALAND: FOREIGN TRADE 1990



EXPORTS BY COUNTRY OF DESTINATION

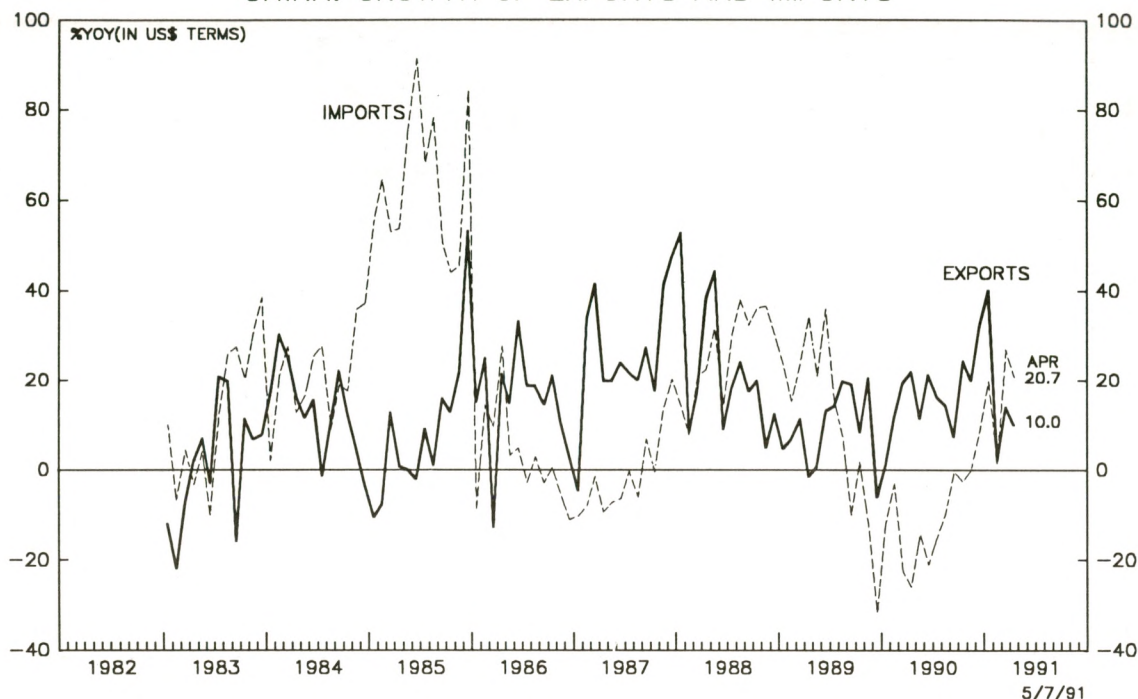


IMPORTS BY COUNTRY OF ORIGIN

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CHINA: THE MFN QUESTIONS

CHINA: GROWTH OF EXPORTS AND IMPORTS



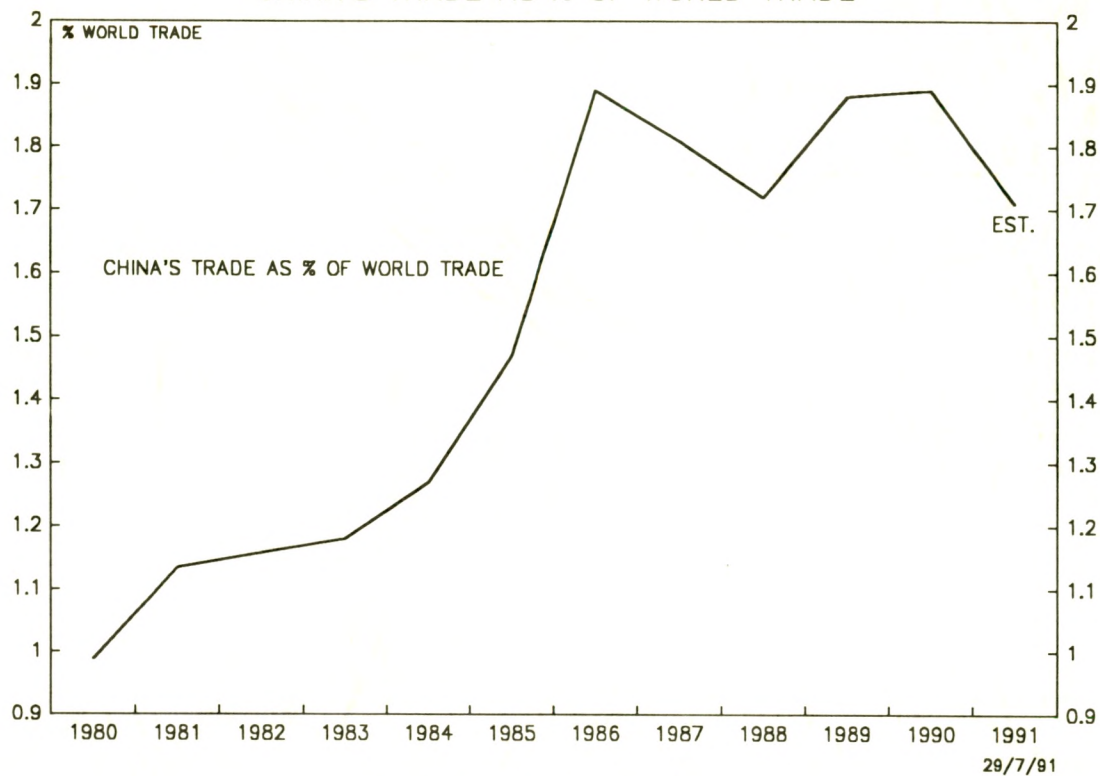
Since the introduction of the "open door" policies in 1979 China's external trade has boomed (chart above, top chart opposite page). Although China's share of world trade is still very small, it grew by more than 72% between 1980 and 1990. The 1988-89 austerity measures led to a sharp drop in the growth of imports which is only now recovering its mid 1989 level. The issue of the renewal for 1991 of China's Most Favoured Nation (MFN) status with the United States raised important political and economic questions. It is now virtually certain that the MFN status will be renewed without any conditions attached. Its withdrawal would have had significant consequences for the export trade of both China and Hong Kong. Tariffs on various exported products from countries without the MFN status can be as much as 900% higher compared to those charged under the status.

The trade balance (bottom chart, opposite page) has turned positive since May 1990. American sources put China's surplus with the US at US\$10.4 bn in 1990 and likely to rise in 1991 to US\$12 bn.

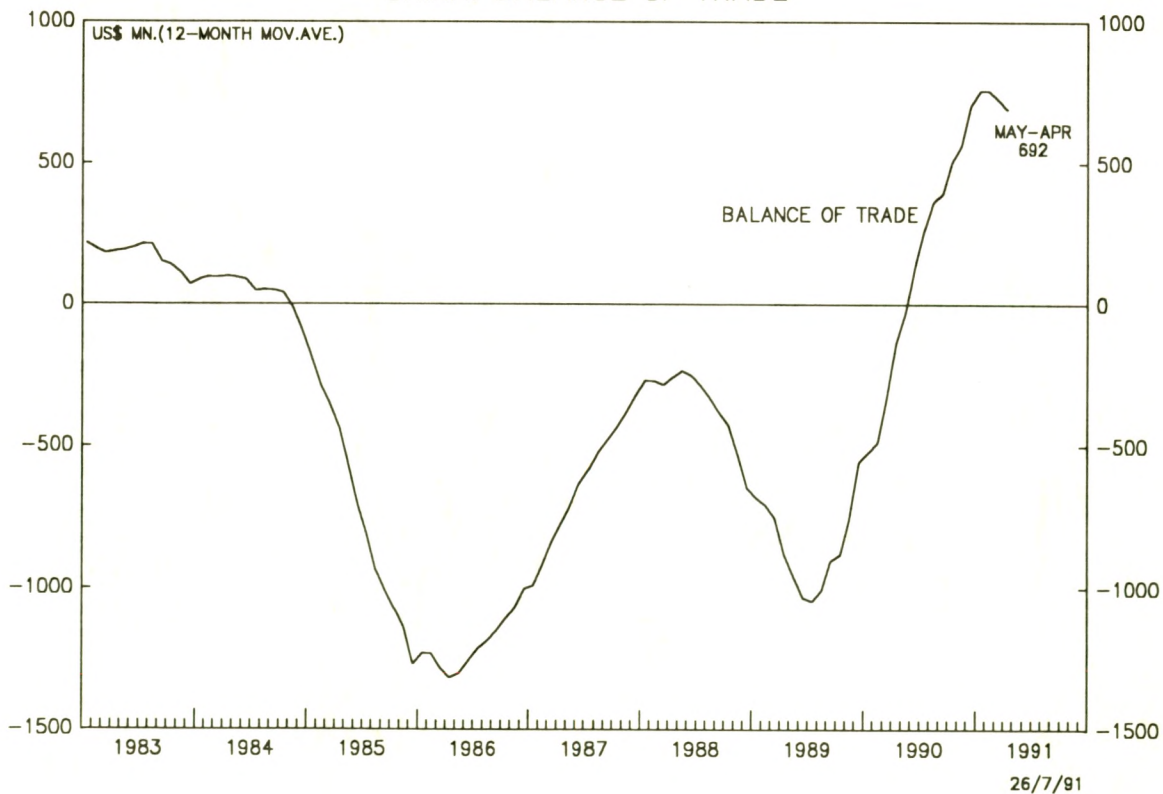
According to Chinese statistics, in 1990 8.3% of its exports were destined for the United States. However if re-exports from China to the US through Hong Kong are added, the share increases dramatically to 25% of total. In 1990 these Chinese re-exports to the US via Hong Kong accounted for 13% of Hong Kong's total exports or nearly 20% of all its re-exports. Higher tariffs would have had a significant impact on the external trade of both of these economies and hence on their GDP growth rates.

It is encouraging, however, to see that the political consequences of the economic damage that the removal of the MFN status would have caused to both China and Hong Kong helped to sway the decision.

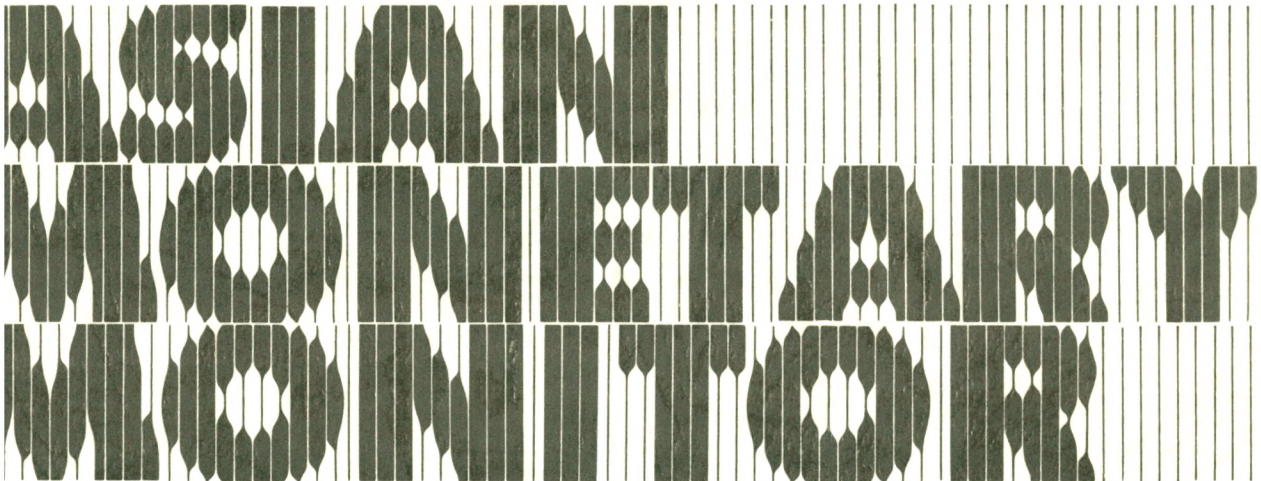
CHINA'S TRADE AS % OF WORLD TRADE



CHINA: BALANCE OF TRADE







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ASIAN MONETARY MONITOR

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REGIONAL SURVEY

NORTHEAST ASIAN AND SOUTHEAST ASIAN BUSINESS CYCLES, AND PROSPECTS FOR 1992.

Despite the emergence of Japan and the EC as major economic powers in the past decade or so, the US economy remains the most important economic influence on the business cycles of the smaller East Asian economies. This is so both for monetary reasons as well as on account of Asia's extensive trade links with the USA (see Table 1). The recent US economic expansion which lasted from the fourth quarter of 1982 to the second quarter of 1990 (Chart 1) was the longest peacetime expansion uninterrupted by any significant downturn in US history, though there was a noticeable "mid-course correction" in 1985-86. However, for the smaller Asian economies (excluding Japan) the parallel business expansion over this period was clearly split into two separate upturns (Chart 2). The first upswing, which mainly benefited the North East Asian economies (Korea, Taiwan and Hong Kong), lasted through 1983 and 1984, while the second upswing, from 1986 onwards, was somewhat short-lived in the North East Asian economies and was already showing signs of slowing down by 1988. The South East Asian economies (the five major ASEAN countries) by contrast, have continued to grow rapidly and in many respects have only recently passed the peaks of their respective business cycles.

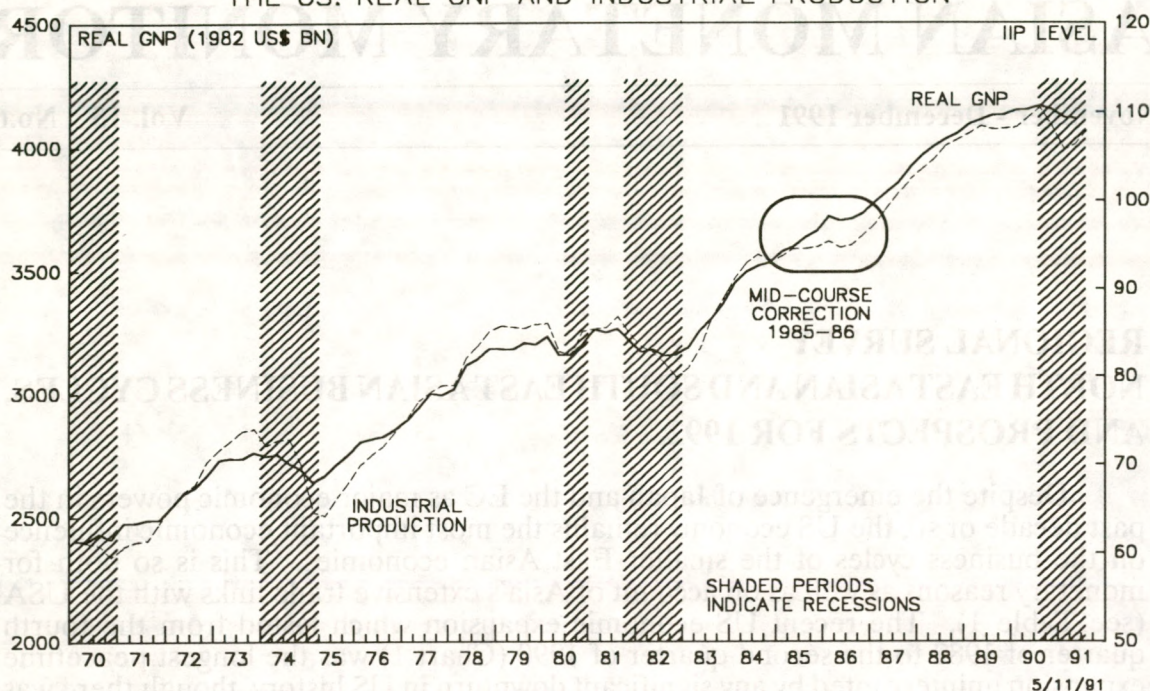
TABLE 1.

ASIAN EXPORTS TO THE US AS A % OF TOTAL EXPORTS.

	<u>1985</u>	<u>1990</u>	<u>Average</u>
Japan	37%	32%	
Hong Kong*	44%	29%	} 30%
South Korea	36%	30%	
Taiwan	48%	32%	
Singapore*	25%	27%	
Malaysia	13%	17%	} 17%
Thailand	20%	23%	
Indonesia	21%	13%	
Philippines	35%	37%	

*Domestic Exports

CHART 1
THE US: REAL GNP AND INDUSTRIAL PRODUCTION



The reasons for these divergent performances between North East Asia and South East Asia can be found in the differing export mix of the North East Asian economies and the South East Asian economies, as well as in differential currency movements versus the US dollar in the two sets of countries. Briefly, the North East Asian countries benefited most in the early stages (1983/84) because their product mix was more concentrated on manufactured goods directed to the final user, i.e. the US consumer. Hence the faster growth of North East Asian exports in the period 1983-84 than South East Asian exports (Chart 3). The South East Asian economies by contrast, began the 1983 upswing with a much heavier commitment to commodities and capital goods, both of which tend to respond only when the business cycle upswing is quite mature.

Moreover, the South East Asian economies, particularly Singapore, Malaysia and Indonesia had made specific errors of macro-economic management in the period 1980-84. These errors led to serious problems which in turn prevented these three economies from benefiting as much from the initial thrust of the US upturn as they otherwise might. In Singapore's case the errors were (a) a policy of deliberately encouraging certain industries (computer components, ship-repair, and offshore oil drilling services) which later ran into problems, (b) draining resources from the private sector to promote the public sector, and (c) a policy of deliberate wage-hikes intended to force Singapore's industrialists to shift to higher technology activities, a policy which in the end merely threatened to make the country uncompetitive. In the

CHART 2

REAL GDP WEIGHTED GROWTH RATES OF N.E. ASIA, S.E. ASIA AND THE US

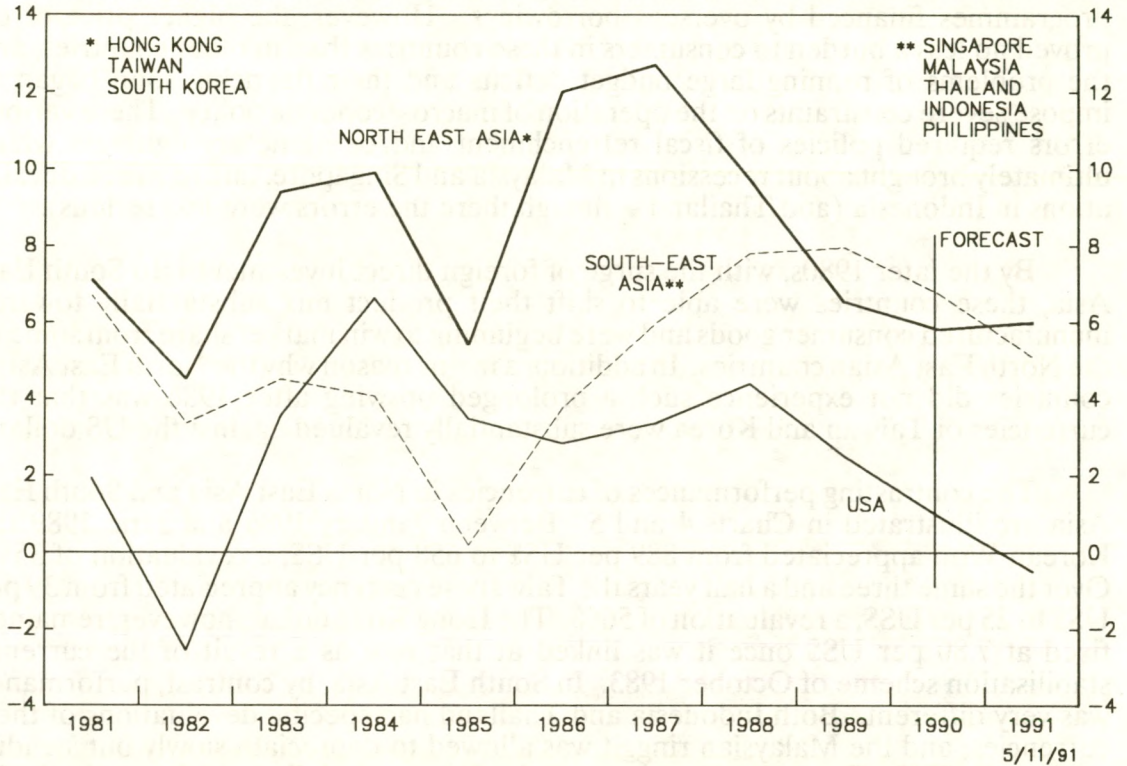
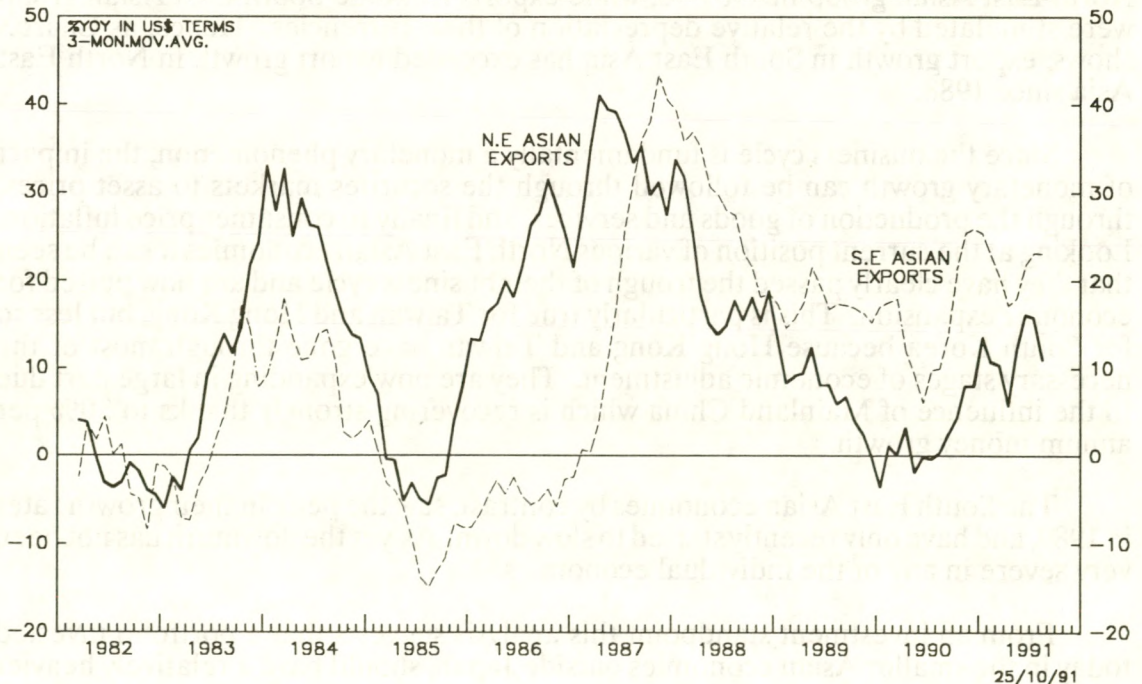


CHART 3

GROWTH OF EXPORTS OF N.E ASIAN AND S.E. ASIAN ECONOMIES



case of Malaysia and Indonesia both countries, being oil producers, took advantage of the "second oil shock" of 1979-80 to indulge in major public sector capital spending programmes financed by overseas borrowings. However, the higher price of oil proved no less a burden to consumers in these countries than in other countries, and the problems of running large budget deficits and their financing soon began to impose severe constraints on the operation of macro-economic policy. These various errors required policies of fiscal retrenchment and/or monetary tightness which ultimately brought about recessions in Malaysia and Singapore, and required devaluations in Indonesia (and Thailand -- though there the errors were less serious).

By the later 1980s, with the surge of foreign direct investment into South East Asia, these countries were able to shift their product mix substantially towards manufactured consumer goods and were beginning to win market share from some of the North East Asian countries. In addition, a major reason why the North East Asian countries did not experience such a prolonged upswing after 1986 was that the currencies of Taiwan and Korea were substantially revalued against the US dollar.

The contrasting performances of currencies in North East Asia and South East Asia are illustrated in Charts 4 and 5. Between January 1986 and June 1989 the Korean Won appreciated from 889 per US\$ to 658 per US\$, a revaluation of 35%. Over the same three and a half years the Taiwanese currency appreciated from 39 per US\$ to 25 per US\$, a revaluation of 56%. The Hong Kong dollar, however, remained fixed at 7.80 per US\$ once it was linked at that rate as a result of the currency stabilisation scheme of October 1983. In South East Asia, by contrast, performance was very different. Both Indonesia and Thailand had specific devaluations of their currencies, and the Malaysian ringgit was allowed to depreciate slowly but steadily against the US\$. The only exception was the Singapore dollar which was gradually revalued upwards between 1987 and 1991, from around S\$ 2.20 per US\$ to around S\$ 1.70 per US\$. The net effect of these movements was to undercut export growth of the North East Asian group in 1989-90, while exports from the South East Asian group were stimulated by the relative depreciation of their currencies. Hence, as Chart 3 shows, export growth in South East Asia has exceeded export growth in North East Asia since 1988.

Since the business cycle is fundamentally a monetary phenomenon, the impact of monetary growth can be followed through the securities markets to asset prices, through the production of goods and services, and finally to consumer price inflation. Looking at the current position of various North East Asian economies it can be seen that they have clearly passed the trough of their business cycle and are now poised for economic expansion. This is particularly true for Taiwan and Hong Kong, but less so for South Korea because Hong Kong and Taiwan have gone through most of the necessary stages of economic adjustment. They are now expanding in large part due to the influence of Mainland China which is recovering strongly thanks to 30% per annum money growth.

The South East Asian economies by contrast, saw the peak in their growth rates in 1989, and have only recently started to slow down. As yet the downturn has not been very severe in any of the individual economies.

From an investment standpoint this analysis suggests that a portfolio invested today in the smaller Asian economies outside Japan, should have a relatively heavier

CHART 4
NE ASIAN CURRENCIES VERSUS THE US\$

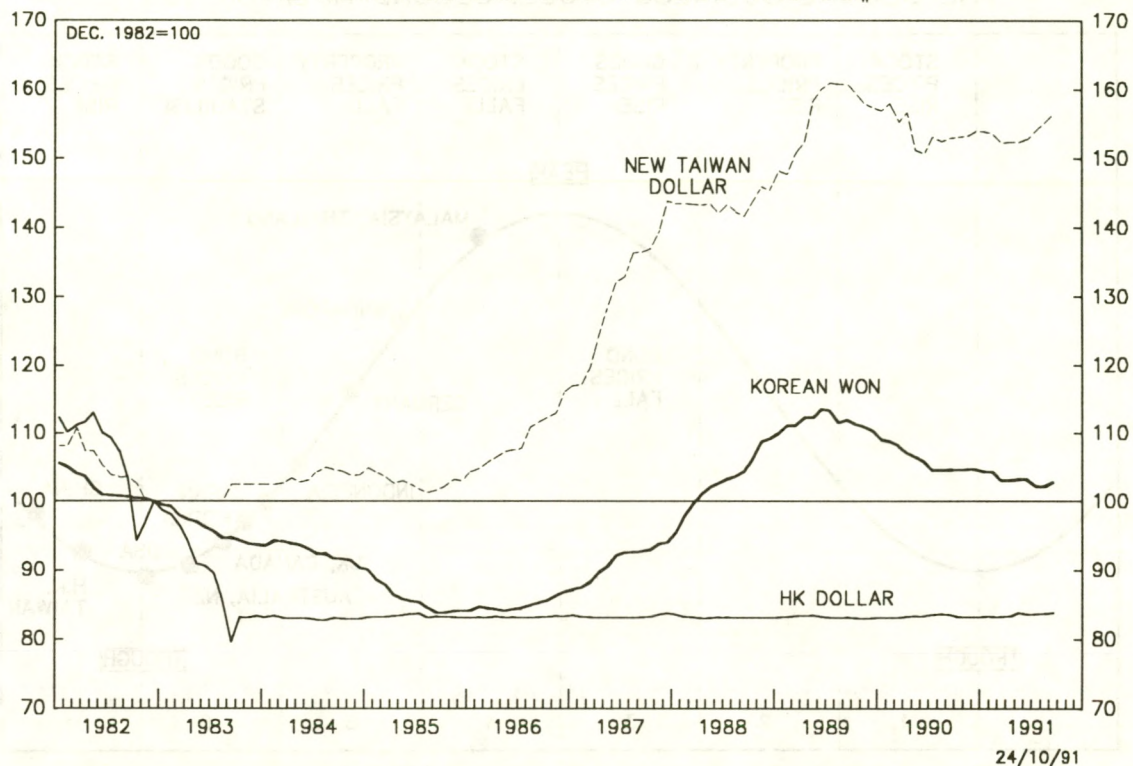


CHART 5
NE ASIAN CURRENCIES VERSUS THE US\$

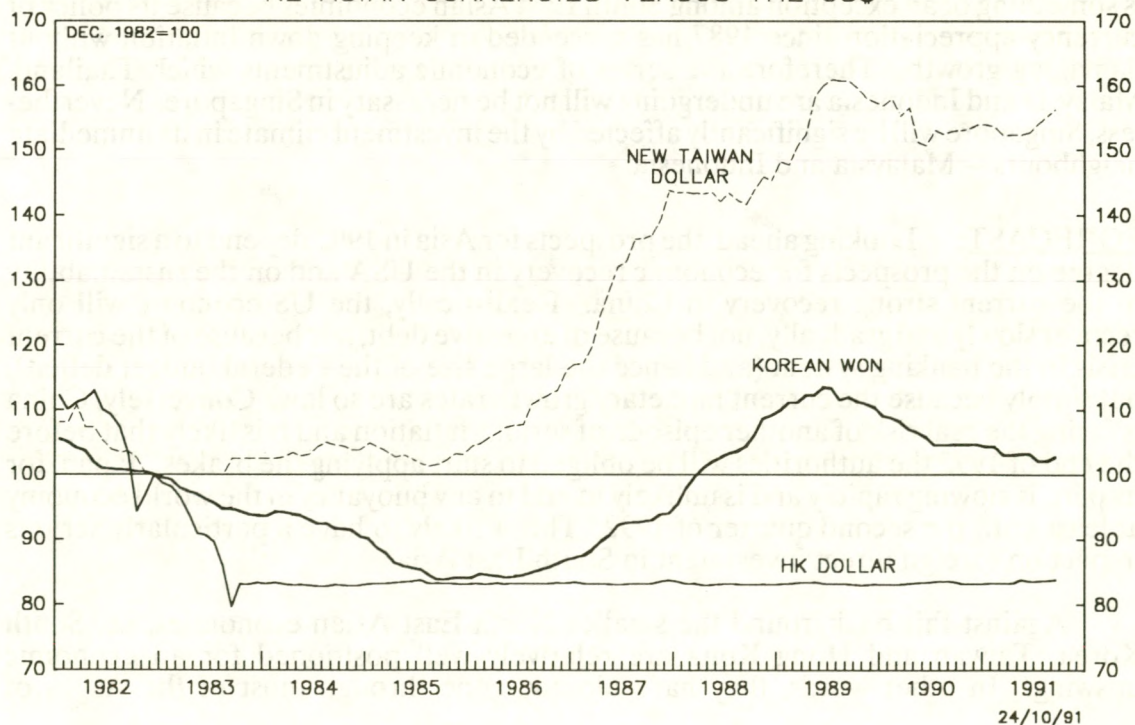
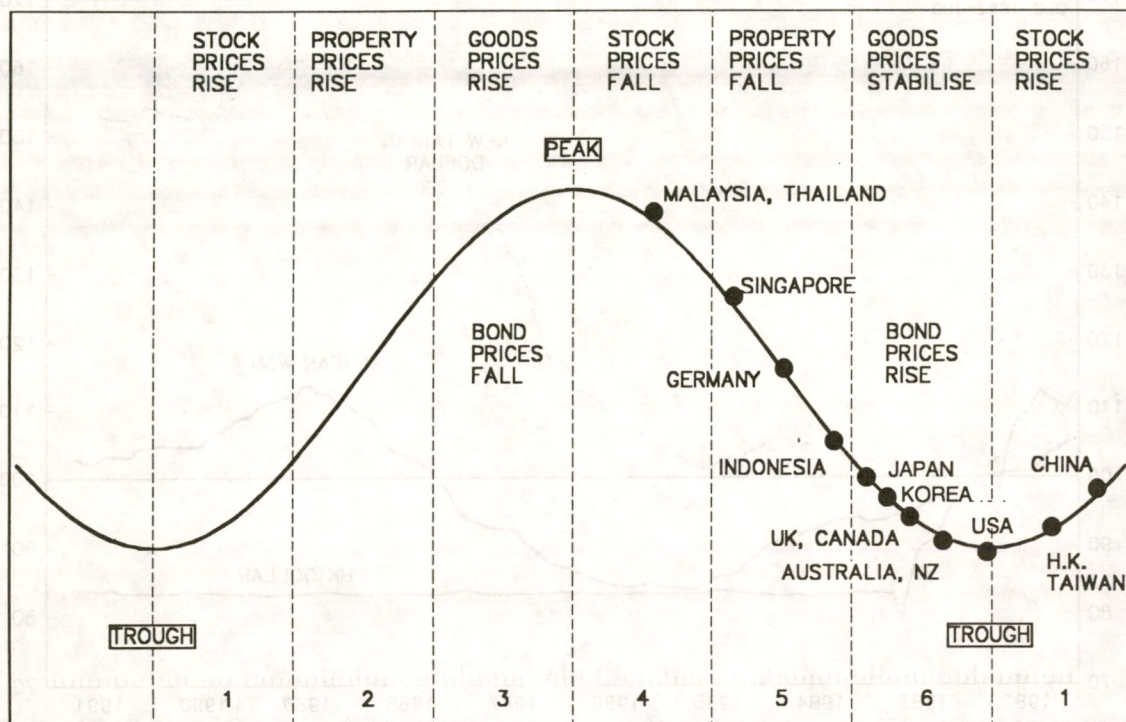


CHART 6
THE GLOBAL BUSINESS CYCLE: SECOND HALF OF 1991



weighting in Hong Kong, Taiwan and perhaps Korea than in the economies of South East Asia -- particularly Malaysia, Thailand and Indonesia (see Chart 6.) Singapore is something of an exception among South East Asian economies because its policy of currency appreciation since 1987 has succeeded in keeping down inflation without damaging growth. Therefore the series of economic adjustments which Thailand, Malaysia and Indonesia are undergoing will not be necessary in Singapore. Nevertheless, Singapore will be significantly affected by the investment climate in its immediate neighbours -- Malaysia and Indonesia.

FORECAST: Looking ahead, the prospects for Asia in 1992 depend to a significant degree on the prospects for economic recovery in the USA and on the sustainability of the current strong recovery in China. Realistically, the US economy will only recover slowly and gradually, not because of excessive debt, nor because of the current crisis in the banking system (and hence the large size of the Federal budget deficit), but simply because the current monetary growth rates are so low. Conversely, China is facing the real risk of another episode of serious inflation and it is likely that before the end of 1992 the authorities will be obliged to start applying the brakes. Japan, for its part, is slowing rapidly and is unlikely to add to any buoyancy in the world economy at least until the second quarter of 1992. This is likely to have a particularly serious impact on foreign direct investment in South East Asia.

Against this background the smaller North East Asian economies, i.e. South Korea, Taiwan and Hong Kong are relatively well positioned for an economic upswing. In other words, they have already gone through most of the stages of

economic adjustment and should benefit substantially from a strong US economic recovery. They have spare capacity (e.g. in Taiwan, and, for Hong Kong in Guangdong Province), inflation is not a problem for export competitiveness, interest rates are falling, and the external balance of payments does not constitute a constraint. (Korea is something of an exception in this regard among North East Asian countries because the stock market bail-out plan in December 1989 led to a sharp acceleration of money growth, faster real growth in 1990, plus a resurgence of inflation, and a deterioration in Korea's external accounts.) By contrast, the economies of South East Asia, particularly Thailand, Malaysia and Indonesia are still dealing with the problems of over-expansion and overheating that have built up in the last two years. Interest rates are rising in Malaysia, current account deficits are widening in Thailand and Malaysia and inflation is a problem in all three economies. Unless these problems of overheating are addressed more seriously, there is a real risk that South East Asia could still be trying to cope with the symptoms of overheating when the global recovery arrives. Even though these economies are now much more dependent on the exports of manufactured goods -- and hence will be more influenced by developments in the US than in the past -- they could be left struggling with the problems of over-expansion in the past rather than benefiting fully from the opportunities of the next global business upswing.

One possible scenario is that the US economic recovery is delayed even further, giving the South East Asian economies time to put their houses in order ready for the next upswing starting in late 1992 or early 1993. Realistically, this scenario seems increasingly less likely as time goes on. The more likely outcome, is that in some degree the experience of 1983-84 will be repeated -- i.e. the early benefits of the global upturn will mostly be captured by North East Asia, whereas South East Asia will mainly benefit in the later stages of the economic upswing.

HONG KONG AN ANALYSIS OF THE EXCHANGE FUND BILLS PROGRAMME: MARKET MICROSTRUCTURE AND PERFORMANCE

by

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Since March 1990, the Government of Hong Kong has been issuing debt for the account of the Exchange Fund. These debt instruments, called Exchange Fund Bills, currently exist for 91-day, 182-day, and 364-day maturities. Recently, the government also announced its intention to begin issuing longer maturity bonds.

The Bills constitute an important contribution to the developing Hong Kong money market. A money market is defined broadly as the market for low-risk, highly liquid, short term debt, and here includes Commercial Paper, Certificates of Deposit, Floating-Rate Notes, and several other Hong Kong dollar (HKD) instruments. By far the most actively traded of these instruments on the secondary market are the 91-Day Bills. In contrast, most other debt instruments are rarely, if ever, traded on the secondary market in Hong Kong. (See AMM Sept-Oct 1990)

This article begins with a discussion of the mechanics of the government debt market at the primary level, including a description of the Bills and their auction mechanism. The next section discusses the secondary market for Bills, including market participants, returns to holding Bills, and supplying the market with liquidity. The section closes with some empirical details of the market. Section Three outlines some common criticisms of the Bills market and proposes several solutions. Section Four offers a summary and conclusion.

I. The Primary Market

A. Description and Status of the Bills

Exchange Fund Bills are "issued by the Hong Kong Government for the Account of the Exchange Fund under the Exchange Fund Ordinance." (Secretary for Monetary Affairs, 1990) The issue of 91-day Bills began on 14 March 1990 with a HK\$300 million auction, with the latter two maturities introduced on 31 October 1990 and 27 February 1991, respectively. As of 6 March 1991, the government also announced its intention to inaugurate a programme for longer term bonds, starting with a two-year maturity and then perhaps moving to three years and beyond. On 15 September 1991, the total open interest in the Bills market was HK\$12,300 million.

The Bills are denominated in Hong Kong dollars with a face value of \$500,000 and exist in book-entry form exclusively. The Monetary Affairs Branch (MAB) maintains a "Bills Register" on which the ownership of all outstanding Bills is recorded.

A notable feature of the Bills is their tax status. Even now, the details of this issue remain unclear. According to the MAB, "The Bills are exempt from profits tax and stamp duty." In practice, however, after-tax yields on Bills may vary from

and stamp duty." In practice, however, after-tax yields on Bills may vary from institution to institution, depending on several factors.

The first is an institution's source of funds. Under current Hong Kong apportionment regulations, income from the Bills is exempt from taxation, but the cost of financing purchases of these Bills is not tax deductible. Therefore, institutions with a larger access to "free money" (i.e. a large HKD retail deposit base) get a much bigger after-tax yield from holding Bills than institutions which are required to borrow most of their funds interbank.

Second, corporate accounting arrangements can affect post-tax Bill yields. Indeed, even some retail banks may be denied the full extent of the Bills' tax exemption. For example, if the merchant banking side of a bank handles Treasury dealings but the retail banking side has access to the deposit base, it may be difficult or impossible for internal accounting to accommodate the tax advantage of having access to a large stock of "free money". In addition, the source of funding must be "proven" to get the tax benefit, giving rise to a substantial amount of uncertainty as to the precise tax benefits from holding Bills.

B. The Auction Cycle

Exchange Fund Bills are sold on the primary market by auction. At present, 91-day Bills are auctioned every week, 182-day Bills every two weeks, and 364-day Bills every four weeks. Tenders are open only to those institutions acknowledged by the MAB as Recognized Dealers. To be a recognized dealer, the MAB requires institutions to have adequate capitalisation, adequate creditworthiness, access to the interbank market, and to be subject to prudential regulation.

The Director of the Office of the Exchange Fund determines the size of each issue and announces it at least four business days prior to the auction. The maximum amounts which can be issued at one auction are HK\$500 million for 91-day Bills, HK\$400 million for 182-day Bills, and HK\$300 million for 364-day Bills. In addition to the amount issued, the Exchange Fund also issues additional Bills and holds them in reserve. These reserve holdings represent 20 per cent of the issue size for 91-day and 182-day Bills, and 30 per cent of the issue size for 364-day Bills. The role of these reserves is discussed later.

When Recognized Dealers submit their tenders, they apply on a bid-yield basis -- i.e. they submit the face value tendered for and the yield bid to two decimal places. The minimum size of a tender is the face value of one Bill, and dealers may freely submit multiple bids with differing yields. Tenders are then accepted on an ascending yield basis. Dealers whose bids are accepted are allocated their Bills at their bid price, thus ensuring that there is no "single price" in the Bills auction.

While the MAB reserves the right to create additional Bills for "last resort supply and lending," the amount of Bills allotted at auction does not exceed the amount offered at tender. Moreover, the Secretary for Monetary Affairs reserves the right to reject any part or all of a tender to prevent the market in a particular issue from being cornered at auction, though this determination is subjective.

Payment for Bills on the primary market is exacted on the Wednesday following

Tuesday's auction. Settlement is through the direct debit of Recognized Dealers' clearing accounts or their bank. This procedure is executed through The Account of the Hongkong and Shanghai Banking Corporation (HSBC) at the Exchange Fund. (For a discussion of The Account, see AMM July-Aug 1988.) Through this mechanism, the Fund can use the Bills market to exert pressure on interbank liquidity, hence monetary policy.

To exert an influence on the HK\$/US\$ rate using the Bills market, the Fund need only purchase or sell these Bills. This may either be done on auction day or on the secondary market. Assume that the Fund wishes to apply upward pressure on the foreign exchange rate by buying HK\$500 million on or just before an auction day. It can accomplish this by settling the auction through The Account and not "neutralising" the sale. At an auction of HK\$500 million of 91-day Bills, the Fund merely sells the Bills and debits The Account (i.e. lowers the Fund's liability to the HSBC) by HK\$500 million. This eventually precipitates a tightening of interbank liquidity, higher interest rates, and a firmer HK\$. (For the mechanics of this process, see AMM July-Aug 1988, and AMM March-April 1990.)

Alternatively, the Fund may wish to keep the Balance in The Account unchanged. If this is the case, then the Fund must redeposit the proceeds from the auction into the accounts of the Exchange Fund in the commercial banking system. Yet, the Fund may still influence relative interbank liquidity. Say, for example, a kink upward in 1 month money is evident in interbank rates. Then, an auction of three-month Bills may prompt the Fund to recirculate the proceeds by lending at 1 month interbank, thus smoothing the kink. Yet, as long as the HK\$500 million is loaned into the interbank market, overall interbank liquidity will remain unchanged.

This ability to influence interbank liquidity by conducting "open market operations" is one of the main stated reasons the MAB began issuing government debt. This instrument will make it easier for the Fund to intervene in the determination of interest rates and the preservation of the linked rate in the future, though it has the unfortunate side-effect of moving the Fund further down the path toward a central bank.

Aside from this monetary policy objective, the MAB may also have had future public financing needs in mind when it began issuing debt. To date, the Hong Kong government has only occasionally ever run a fiscal deficit. However, with the Port and Airport Development Scheme (PADS) now predicted to cost HK\$127 billion, some borrowing may eventually be necessary, and the existence of a liquid debt market will make such government borrowing much easier.

II. The Secondary Market

A. Market Participants

Market participants in the primary market, Recognized Dealers, are those institutions allowed to submit tenders for Bills at auction. In addition, dealers may transact in the secondary market by instructing the MAB to execute transfers in the Bills Register for their own account or the account of a client. Short selling is allowed by Recognized Dealers, though they may not maintain a short position at closing time in any particular issue of Bills.

Recognized dealers may also enter sale and repurchase ("repo") agreements, in which Bills are sold with the agreement that they will be repurchased from the same counterparty at a later date. Additionally, dealers may borrow and lend Bills, particularly if they need to do so to cover short positions. The latter type of transactions are more common for very short time horizons, whereas repo's may be used more frequently for effectively borrowing over a longer period, such as a month.

Of the Recognized Dealers, the MAB selects the twenty applicants it deems the most financially stable to become "market makers" on the secondary market. Market makers are charged with the continuous quotation of two-way prices (bids and offers) in any issue of Bills during normal secondary market trading hours -- 9:00am - 12:00noon and 2:00pm - 4:00pm. As with most markets, the function of a market maker is to supply "immediacy," or liquidity, to the marketplace. When a customer in the Bills market transacts, he faces the choice of transacting later and bearing the risk of a price change, or transacting immediately and avoiding the price risk. These choices and their relative costs define the demand for immediacy, which market makers meet. Yet, meeting this demand by continuously offering to buy and sell Bills can be very costly, as it forces the market maker to bear the price risk that "final customers" prefer to avoid when they demand immediate execution of a transaction. Moreover, the fixed costs of maintaining a continuous presence in the marketplace may be quite high.

In return for supplying the market with liquidity, the MAB awards several perquisites to market makers: (a) market makers may remain short in a particular Bill issue after the close of business -- however, a market maker may not be net short when his position in all Bills is taken together; (b) the Exchange Fund only transacts in the secondary market through market makers; (c) the Fund will make a competitive bid for any Bills a market maker offers; (d) and using the reserves which the Fund holds back at auction, the Fund will act as a lender and supplier of last resort to market makers. (In this way, the Exchange Fund itself acts as the twenty-first market maker, and it also subjects itself to the net short restriction.)

Of the twenty private firms which are currently market makers, eleven are retail banks, while the remainder are merchant banks or restricted license banks. (See Appendix for a list of current market makers.)

B. Holders of Bills

In Hong Kong, virtually all Exchange Fund Bills are held in professional hands. Some estimates suggest that as much as 95 per cent of all Exchange Fund Bills are held in the banking sector. One reason for this is that banks are concerned with a different set of issues than the typical private or institutional investor. Namely, the latter do not tend to concentrate on credit quality and liquidity as much as the bottom-line yield. The availability of "swap deposits" in Hong Kong makes it easy for investors to circumvent the tax system by swapping their money into USD now, then back into Hong Kong dollars later, in the meantime earning interest comparable to the Eurodollar rate. The swap deposit rate is generally in excess of the Bills rate and contains no tax liability. Hence the Bills provide an inferior yield and no real tax advantage to the institutional investor. For this reason, Bills offer very little advantage to the non-banking community.

By contrast, the banking sector can gain significantly from holding Bills. First, some institutions gain outright from the tax treatment of Bills. Chart 1 shows a plot of the 3 month Hong Kong Interbank Offer Rate (HIBOR) minus the closing yield of 3 month Bills on the secondary market over one year. Clearly, the Bills remain at a discount to HIBOR most of the time. However, this does not represent the post-tax yield to holding Bills. Some retail banks reportedly obtain a substantial net premium over HIBOR. Moreover, retail banks face a liquid asset requirement, and these Bills offer another means of satisfying this requirement.

Second, interbank borrowing and lending appear on financial statements as private placements, with the identity of counterparties recorded. Some institutions may be reluctant to transact with particular institutions interbank because they do not wish to have that institution listed as counterparty for credit quality reasons or other idiosyncratic reasons. Since the Bills are backed by the Hong Kong Government, the credit quality concern of interbank lending can be avoided by holding government debt -- the only identifiable counterparty on a balance sheet is the Exchange Fund, as it backs the Bills. Thus the Bills market performs the function of a supplementary or parallel interbank market which allows money market transactions to occur with a certain degree of anonymity and assured creditworthiness.

C. Secondary Market Activity and the Return to Market Making

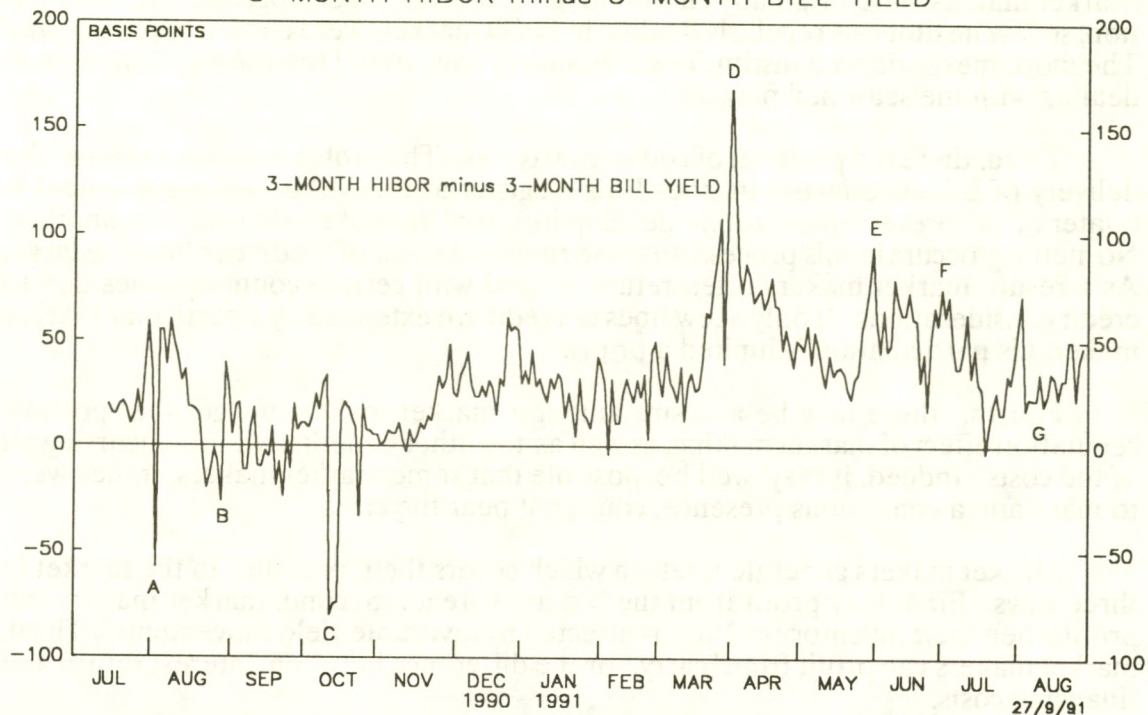
Chart 2 shows the average daily volume in the secondary market for all maturities of Bills. These statistics seem to indicate an increasingly successful market. However, they may be somewhat deceptive. Many market participants interviewed suggested that much of this activity is confined to only a few market makers, trading largely amongst themselves.

Market makers fall into two tiers. One major participant's estimate suggests that the first tier of participants is comprised of roughly eight market makers, which quote a five basis point spread amongst themselves and have a large average transaction size. The second tier of market makers is comprised of institutions quoting a seven to ten basis point spread and dealing with smaller-sized transactions. While no explicit regulation exists, market makers are effectively prohibited from offering more than a ten basis point spread.

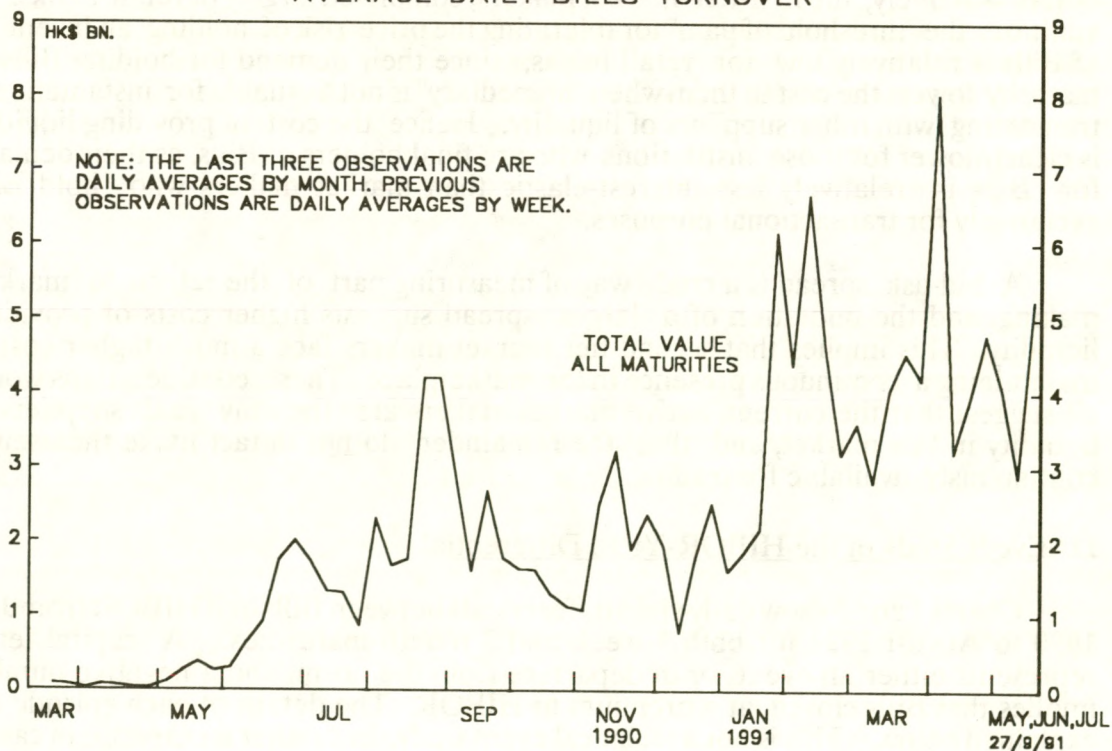
The second tier of market makers is dominated by a group of players who rarely participate in the market. Numerous complaints have been leveled at many of these institutions with regard to their delays in answering phone calls, persistent appointments and meetings during trading hours, refusal to deal with institutions because of questionable credit, etc. In short, this group of market makers seems to enjoy the benefits of being a market maker without incurring the cost of maintaining a continuous presence in the marketplace.

Several things might explain this non-participation. First, the larger retail institutions in the first tier are those institutions most influential in the Hong Kong Association of Banks (HKAB) interest rate cartel. As such, they may have foreknowledge about the direction of interest rate changes which gives them an advantage in structuring their short-term Bills portfolio over second tier participants, giving rise to an outright transfer of wealth between the two groups.

HONG KONG: CHART 1
3-MONTH HIBOR minus 3-MONTH BILL YIELD



HONG KONG: CHART 2
AVERAGE DAILY BILLS TURNOVER



Second, the second tier of market makers may simply be inexperienced. Market makers were originally chosen to give a diversified geographic representation, so few institutions regularly dealing in HKD markets were chosen to participate. The more inexperienced institutions may simply have found themselves incapable of dealing with the seasoned players.

Third, there is a problem of counterparty risk. The problem arises because the delivery of Bills is effected in the Bills Register at the MAB, while settlement is bilateral. At present, institutions develop informal lines of credit with one another. No netting occurs in this process, so these required lines of credit can become large. As a result, market makers often refuse to deal with certain counterparties due to credit considerations. If only a few lines of credit are extended by a particular market maker, his participation is limited a priori.

Fourth, there may be a desire amongst market makers to get the positive reputation effect of market making, as well as the other benefits, without incurring all of the costs. Indeed, it may well be possible that some market makers, if they were to maintain a continuous presence, could not bear the costs.

Market makers generate a return which covers their presence in the market in three ways. First, they profit from the bid-ask spread. Second, market makers can profit when their inventory of Bills is affected by favorable yield movements. Third, market makers can profit from "carry," or the difference between interest return and financing costs.

In the Bills market, the differential tax treatment makes the carry strongly negative for some market makers (see Chart 1), while almost always positive for others -- namely, the first-tier market makers, comprised largely of retail banks. In addition, the "threshold of pain" for tolerating the price risk of holding an inventory of Bills is relatively low for retail banks, since their demand for holding Bills to maturity lowers the cost to them when "immediacy" is not available for instantaneous transacting with other suppliers of liquidity. Hence the cost of providing liquidity is clearly lower for those institutions who are final holders of Bills, as their demand for Bills is relatively less interest-elastic than market makers who hold Bills exclusively for transactional purposes.

A bid-ask spread is a crude way of measuring part of the return to market-making, and the quotation of a larger spread suggests higher costs of providing liquidity. This implies that second-tier market makers face a much higher cost of maintaining a continuous presence in the marketplace. These considerations would all suggest that the current, active market makers are the only real suppliers of liquidity in this market, and that the remainder do not in fact make themselves continuously available for trading.

D. Event Study of the HIBOR-Yield Differential

Charts 1 and 3 show daily yield differentials between Bills and HIBOR from July 1990 to August 1991 for both 1 week and 3 month maturities. A capital letter represents either an event or a departure from the norm, and a negative number implies that Bills closed at a premium to HIBOR. The details of each episode are explained below. (This is not a technical event study, but rather an exercise in casual

empiricism.)

A (3/8/90) -- This was the date on which rumors of an Iraqi invasion of Kuwait were first reported in the Hong Kong financial markets. Between August 2 and August 3, both one week and three month bill yields climbed over one hundred basis points. HIBOR, by contrast, rose only moderately, leading to a 90 basis point premium of Bills over HIBOR at one week and a 71 b.p. premium at three months. This suggests that the Iraqi invasion of Kuwait actually reduced the demand for Bills in the short-term. This is the opposite of what might be expected in a normal high credit quality market -- political uncertainty tends to create a flight to quality. However, this might be explained by a fear amongst banks that the political uncertainty in the Middle East would lead to a banking panic in Hong Kong, thus causing banks to liquidate Bills for cash. Additionally, the expected increase in oil prices fueled inflationary fears, hence expectations of an interest rate hike abroad.

B (23/8/90) -- At the close on this day, one week Bills were at a large 112 b.p. premium to HIBOR, while one-month and three-month Bills only posted a 25 and 20 b.p. premium respectively. Market commentary suggested that rumours of a U.S. interest rate hike were responsible. However, the fact that HIBOR did not respond to this rumour while the 1-week Bills did, suggest (a) that the effect on Hong Kong interest rates was uncertain, and (b) that the 1-week Bills were being used to hedge against the possibility of an interest rate hike or to reflect expectations of such a move.

C (12/10/90) -- All Bills maturities were at a large premium to HIBOR, resulting from a close-to-close appreciation of Bill yields combined with a close-to-close decline in interbank rates. Market commentary suggested thin trading, several times dominated by large participants.

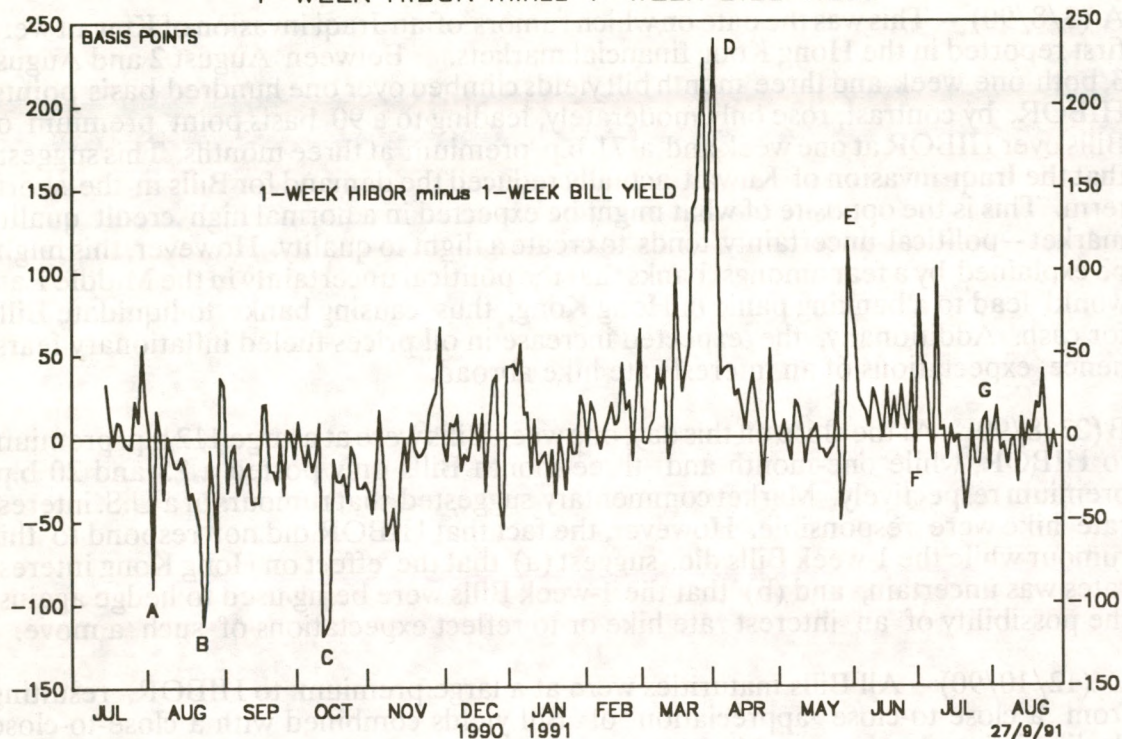
D (22/3/91 - 4/4/91) -- During this period, short Bill yields moved steadily to record discounts vis-a-vis HIBOR, reaching a 239 b.p. discount at one point. Over the first part of the period, Bill yields declined steadily, with HIBOR staying roughly the same. Later, HIBOR gradually fell and closed the differential. Market commentary suggests that this phenomenon was due entirely to one large market maker accumulating a huge position at the short end of the Bills market, followed several days later by the same market maker adding large amounts of reserves to Hong Kong money markets.

E (31/5/91 - 6/3/91) -- On 24/5/91, a one percent increase in the BLR was announced, which led to no abnormal differential -- Bill yields, deposit rates, and interbank rates immediately responded with up to a two hundred b.p. increase at the one week maturity level, but the HIBOR-Yield differential remained stable. However, market commentary suggests that the market overreacted to the interest rate hike, so the Bill yields began to tumble around the 31st of May. As the Bills market adjusted downward, Bill yields went to a big discount to HIBOR. Several days later, the interbank market adjusted downward as well, closing the differential.

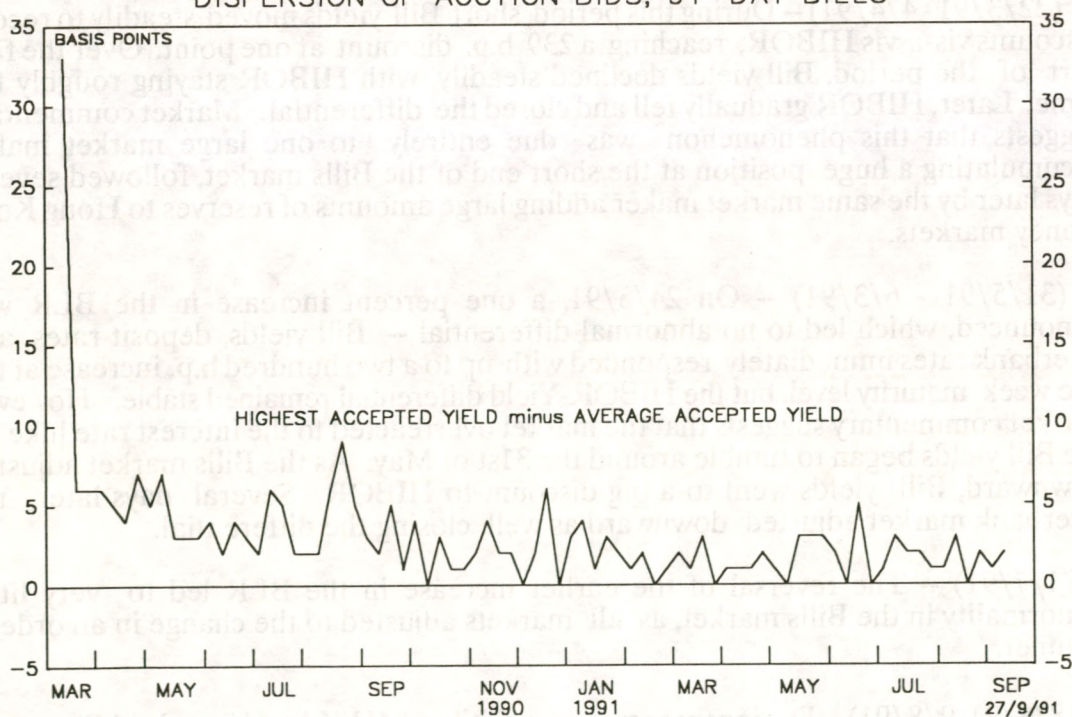
F (1/7/91) -- The reversal of the earlier increase in the BLR led to very little abnormality in the Bills market, as all markets adjusted to the change in an orderly manner.

G (8/8/91, 9/8/91) -- During these two days, Citibank (H.K.) and Standard Chartered

HONG KONG: CHART 3
1-WEEK HIBOR minus 1-WEEK BILL YIELD



HONG KONG: CHART 4
DISPERSION OF AUCTION BIDS, 91-DAY BILLS



Bank suffered relatively large local bank runs. In such circumstances, one might expect a flight to quality. However, this did not occur. This is easily explained when we recall that banks are the primary holders of Bills. The behaviour of the differential on these days suggests that either banks were borrowing HIBOR relatively more than flocking to Bills, or that banks were liquidating Bills. Either action could have been prompted by an increased demand for short-term cash to stave off potential depositor runs.

III. Market Problems and Proposals for Reform

A. Problems of the EFB Market

There are several criticisms of the Bills market, which were either leveled by market participants or emerge from an economic analysis of the market.

(1) There is no single market.

Numerous market makers complained of being overworked in the Bills market. This supposed excessive workload has led to several complications. First, price quotations are often delayed and the Reuters screens on which market makers are supposed to update prices are very rarely used. Second, the high workload has created a tendency for "the" market to degenerate into a series of bilateral transactions, giving rise to inefficiencies stemming from multiple prices, the differences between which exceed the costs of arbitrage.

Moreover, the relatively small number of active market makers has given rise to allegations of oligopolistic behavior. The event study above confirms that large institutions seem to have a considerable degree of influence on Bill yields. Moreover, the structure of the market makes oligopoly and collusion more likely by discouraging ownership of the Bills outside the banking sector, due largely to the tax benefits of the Bills and their inferior yields. The lack of a centralized information flow contributes to this problem by limiting the transparency of transactions.

All this has generated a market characterised more by bilateralism than by collective trading. Yet, this is no different than any dispersed-dealer market. However, in a highly efficient dispersed-dealer market, such as the U.S. swap market, the prices offered by competing institutions rarely depart from arbitrage boundaries, largely since banks can quote swap prices by doing strip calculations off Eurodollar futures. Bilateralism is not necessarily bad, but the reported high incidence of arbitrage opportunities in the Bills market suggests that it is not processing information efficiently, as a socially beneficial asset market should. Arbitrage itself is generally the process which eliminates such inefficiencies -- as more investors exploit price differences, the differences disappear. Yet, when information about prices is itself unavailable, even arbitrageurs may have a difficult time making prices converge.

One of the major problems of a market characterised by bilateralism and transactional "secrecy" is that it creates a barrier to entry for would-be market participants who are not market makers. A similar problem has existed in the market for U.S. government debt for some time, with many outside the select group of "primary dealers" criticising it as an oligopoly. In the early 1980's, Wall Street firm Lazard Freres & Co. attempted to become a secondary market participant in the long-term

U.S. debt market. Believing that it was being cheated by the primary dealers, Lazard demanded access to the secondary dealing screens used by primary dealers. The dealers refused access to Lazard. In a 1987 hearing, the firm summarised its complaint as follows: "The private-club approach [to Treasury dealing]...has limited the depth, breadth and resiliency of the market for government securities. The system should be opened up so that all who are qualified are permitted full access....This approach will benefit both investors and ultimately the government itself, since the net effect will be drive down the cost of borrowing." *

The criticisms leveled by Lazard at the U.S. debt market may be equally applicable to the closed-door market in Exchange Fund Bills in Hong Kong.

(2) The short-selling restriction constrains market participants.

Since market makers may not be net short, some fear that they are prevented from taking full advantage of portfolio optimization. However, this is not accurate. Because the net short restriction is not enforced with respect to cash flow positions, it is easily possible to construct a short interest rate position in the market. For example, a short position in a Bill maturing in one week and a long position in a Bill maturing in three months is considered neutral by the Fund, but the timing of cash flows makes that position significantly short interest rates, because of present value discounting.

However, the short selling restriction does remove some market discipline in checking the ability of large participants to squeeze the market for a particular issue. When anyone tries to corner an issue, it is apparent quickly as the yield of that issue drops below the surrounding issues, which should be very close as they mature within a few days of one another. If such behaviour is observed, then another market maker may simply go short the issue being cornered and offset it with a long position in either of the two surrounding issues. This would only create a small asset/liability mismatch and could bring prices back into line. The existence of a short-selling restriction limits the effectiveness of such operations.

(3) The tax exemption for the Bills is ambiguous and discriminatory.

Many participants complained about the ambiguity of the tax exemption, as noted above. In particular, the uncertainty surrounding this issue makes the return on holding Bills for some institutions questionable, thus seriously affecting the incentives of participants to hold the Bills. Some also complain that the stated tax exemption is itself discriminatory by giving institutions with access to low-cost funding an advantage over other institutions.

Furthermore, since institutions which do receive the tax benefit may get yields over HIBOR, they are getting subsidised rates for lending to the government. In short, the tax issue has created a seriously "unlevel playing field".

* Quoted in David Wessel, "U.S. Treasury Did Wall Street's Bidding," Asian Wall Street Journal, 26 September 1991.

(4) The auction mechanism is flawed.

At present, dealers submit tenders for a specified quantity of Bills at a specified yield, and if their tender is accepted they pay the amount of their bid. This is referred to as "price discrimination", as it involves different purchasers paying different prices for the same good.

This system is problematic for two main reasons.* First, it tends to limit participation in the auctions to primary dealers and market makers, because many non-dealers may be scared away for fear of being stuck with a very low yield. In a single-price auction, by contrast, bidders effectively submit their entire demand curve. A bid might look something like, "I will buy HK\$500,000 of Bills for any yield above 8.5, HK\$1 million for any yield above 8.55, and so on...." The Fund then aggregates these demand curves and sets the auction yield at the level where the total amount tendered at that yield and below equals the supply to be auctioned. All successful bidders pay the same price. Thus, bidders need only indicate the minimum yields acceptable for given quantities of Bills. Hence, a bidder does not lose if he bids a lower yield than the one accepted. This should greatly enhance the appeal of Bills auctions to non-market makers.

Second, the current system encourages collusion. If all dealers pay the price they bid, there is a strong incentive to bid close to the highest accepted yield, thus providing a temptation for bidders to get together and prearrange their tenders. Chart 4 shows the spread between the average yield accepted and the highest yield accepted. The spread has clearly remained relatively small, and on at least nine occasions the average yield accepted and the highest yield accepted have been identical, perhaps suggesting collusive behavior. Explicit collusion has been evident in the British bill market for some time, and more recently in the U.S. government debt market, as the Salomon Brothers controversy highlights. Both of those markets use price discriminating auction mechanisms. (Of course, the fact that Bills are auctioned every week means that secondary market yields on Bills auctioned the previous week should closely resemble auction yields, thus constraining the extent of collusion.)

B. Proposals for Reforming the Bills Market

In considering each of the above problems, it is important to note that no political organization, nor any economist, can dictate the "extent of the market." One of the benefits of a free price system is that it gives economic agents an incentive to "discover" the optimal forms of market microstructure on their own. Problems arise, however, when regulations and structural requirements impose limitations on this discovery process, hence limiting the extent of the market.

* See Milton Friedman, "How to Sell Government Securities", Asian Wall Street Journal, 3 September 1991.

Broadly speaking, two possible forms of the market for Exchange Fund Bills are conceivable. The first rests on the view that the Bills market in Hong Kong should strive for a wide dispersion of ownership and participation. Second, the Bills market can serve an economic function as a parallel interbank market for large HKD players, thus suggesting very limited participation. If the latter organizational form prevails, most participants will be rewarded for holding government debt by subsidised net yields at or above HIBOR.

It is critically important to consider these two possible functions of a government debt market when evaluating any proposed reforms. Since this market is itself a creation of the government, the economic discovery process is impeded and the forces of innovation are placed in check by political design. Thus, the ultimate responsibility for the success or failure of this market relies on the ability of the Exchange Fund to ascertain what the main benefit is to the would-be holders of Bills. This primarily involves defining the "rules of the game" in such a manner as to facilitate the evolution of the market's organizational form toward the social optimum.

If the government does wish to increase the ownership base and not limit the extent of this market to a parallel interbank market with subsidized lending rates, then the following changes are appropriate. If it does not, then the present market structure should be retained.

(1) Eliminate the tax bias.

In order to "level the playing field," the tax issue must be sorted out in an incontrovertible and unambiguous manner. Any potential reform of existing tax treatment should address two concerns. First, no particular institution should be treated differently by the tax exemption of the Bills. Second, the Bills should not create an opportunity for tax arbitrage with other financial instruments.

The ideal compromise would involve two reforms: allowing funding costs to be tax deductible for money market investments, and exempting all money market instruments from the profits tax. If, however, borrowed funds cannot be linked to money market finance, then the latter change alone is the best possible solution.

(2) Centralise the clearing and payments mechanism.

Currently, counterparty risk is both a legitimate problem and a source of potential oligopolistic behavior in the Bills market -- i.e. this risk provides a ready excuse for dealers not to transact with competing institutions which may be a threat to oligopolistic economic rents. This problem could be solved in several ways.

First, netting would provide one means of simplifying the clearing process. This would reduce the amount of actual cash flows and thus limit counterparty risk. However, for netting to be effective, it would be necessary for a fairly large number of institutions to use it. Otherwise, it would present at best a partial solution to counterparty risk, and at worst add confusion to the market.

Second, an independent body could be set up to handle clearing and payments. A clearinghouse typically operates independently from market participants and acts

as a counterparty to all transactions, thus assuming all counterparty risk. It may mitigate this risk by doing extensive credit checks on clearing members, requiring margin payments or performance bonds, or requiring that members pay into an indemnification fund.

Third, a settlement-on-delivery system could be set up, whereby no Bills are actually transferred in the Bills Register until payment has been received.

The best solution seems to be the establishment of an independent, private clearinghouse which operates with netting, settlement-on-delivery, or some creative combination of both. Such a clearinghouse need not interfere with the dispersed dealer nature of the market. As the Bills Register is completely electronic, the clearinghouse could be also. Moreover, the Bills Register should be maintained by the clearinghouse manager to capture a natural economy of scope, i.e. the reduction of average cost from the multiple utilisation of factor inputs. In this case, the transaction information required to maintain the Bills Register is essentially the same as the information which would be used in the settlements process. Thus, one institution could likely utilise this transaction information at a lower cost than two institutions performing separate services with the same production input.

Neither the MAB nor the HKAB Clearinghouse is well-suited to manage this proposed operation. The MAB would be poorly suited simply because it would have too much day-to-day control over the market. The HKAB Clearinghouse would be equally unsuitable, since the HSBC is the manager of it. As the major Bills market participant, this would give the HSBC access to the confidential Bills holdings of all its competitors. The only suitable way to allow the HKAB Clearinghouse organizational responsibility for the Bills clearing function is to divorce it from the HSBC and make it an independent entity -- a reform which has merit in its own right.

(3) Centralise the information flow.

Centralising the information flow and the price reporting in the Bills market would be of considerable benefit, as most market participants interviewed agreed. It would add transparency to the market, thus encouraging wider participation, and decrease price inefficiencies which emerge when bilateral price differences exceed the transactions costs of arbitrage.

Prices could be reported centrally in several ways. First, an independent organisation, such as Telerate, could be used as a price reporter. However, to the extent that current market makers refuse to update Reuters, it is not likely they would update Telerate, nor is it clear who should finance such an operation.

Second, the role of intermediaries and brokers in the Bills market could be enhanced. This would distribute the Bills market workload to another layer of players, thus freeing time for everyone to report prices, as well as diminishing arbitrage opportunities. However, as Adam Smith pointed out in 1776, the division of labour is limited by the extent of the market. If the Bills market remains confined to only a few participants, then broking it would probably not be feasible.

Third, an independent clearinghouse such as the one discussed in the previous section could also serve the function of a price reporter. Acting as the intermediary

for all transactions, it would already have access to all trading, thus giving rise to a further economy of scope in the utilization of information. (Of course, trades would have to be submitted immediately after being consummated.) The price reports could then be dispatched into either a reporting system such as Telerate, to which the market makers would subscribe, or an independent electronic display. It would then be much easier to justify the cost of establishing an independent clearinghouse, since the benefits would be manifold.

Fourth, the market could be moved from "upstairs" to a "floor", thus requiring that an electronic dealing network be set up, hence also solving the price reporting problem. This would also harmonise transaction reporting and price reporting which are currently done separately. This in turn would probably lead to lower transaction costs. An existing dealing network, such as one of the financial exchanges, could be used as a trading arena. If the market is to become more open, then this could greatly enhance its operation. However, if the market is to remain one with relatively limited participation, then attempting to set up a central dealing network might meet with disdain and impede the progress of its development.

(4) Alter the short-selling restriction.

Penalty-free, net short positions should be allowed, at least for short periods of time. This would enhance the ability of market participants to deter other participants from gaining excessive market power in a particular Bills issue.

(5) Reform the auction mechanism.

The auction mechanism should be changed in several ways. First, switching from price discrimination to a single-price auction mechanism would open the primary market to participants outside the banking sector and discourage collusive bidding.

Second, "noncompetitive bids" should be allowed at auction. Such bids involve any individual or institution placing a bid below some amount, say HK\$5 million, which is allocated at the prevailing market price. Even if the present system of price discrimination is retained, such bids should be encouraged, with the Bills allocated to noncompetitive bidders at the average accepted yield. This would increase holdings outside the banking sector by limiting the risk that small allocations at very low relative yields would be accepted.

Third, to mitigate collusion, the MAB should define an optimal, anti-cartel "reserve price," or a maximum acceptable yield prior to the submission of tenders. The academic literature on auctions provides more detail on how to optimally set this reserve price.

(6) Allow any bid-ask spread for market makers.

Bid-ask spreads play a critical role in providing economic returns to market making. Limiting the size of the spread constrains market makers from generating the optimal return on their continuous presence in the marketplace, suggesting that the spread maximum should be altered. If quoting a larger spread makes more market makers viable, then the number of active participants in the first-tier could

increase, hence fostering a more liquid market.

In general it is true that a larger bid-ask spread may discourage customers from transacting in a market. However, simply allowing a large spread will not require existing market makers to broaden theirs -- indeed to attract business, they likely will keep spread as narrow as possible. Yet, constraining the size of the spread prevents market makers from generating optimal returns to the provision of liquidity which may become a very important factor during volatile market moves.

(7) The MAB should ensure that market makers are actually making markets.

One of the most difficult problems to solve in a market is the equilibrium quantity of market makers, hence the optimal provision of liquidity. In order to justify the provision of perquisites to market makers which are denied to recognized dealers, the MAB should make sure that those participants who are market makers are in fact maintaining a continuous presence in the market -- i.e., that they are suppliers of liquidity, rather than occasional participants. Entry of market makers typically occurs until the return of market makers on their asset holdings plus profits from order-matching is equal to the risks of trading and the cost of maintaining a continuous presence in the market. Accordingly, if all the market makers are actually performing market-making functions, then the market can be expected to evolve toward the equilibrium quantity of market makers, hence the equilibrium quantity of liquidity. As it is now, the persistence of inactive market makers makes it difficult to tell whether or not the number of market makers is excessive, low, or optimal -- hence, it is not clear whether or not the level of liquidity in the Bills market is even close to optimal.*

IV. Summary and Concluding Observations

The central issue surrounding the Exchange Fund Bills programme is the extent of the market. As it is currently structured, participation in the market is discouraged by all but a select few within the commercial and merchant banking sector. Yet it is not clear that if opened up to those outside that sector whether the demand would be sufficient to keep the market viable.

Since the Monetary Affairs Branch is the issuing agent for government debt in Hong Kong, it must inevitably assume responsibility for defining the character of the market -- in particular, who will hold the Exchange Fund Bills. Since the MAB has undertaken the responsibility for defining the boundaries of this market, they must do so judiciously and in such a way that the true economic function of the Bills market becomes more apparent than it is at present. To that end, the MAB faces two distinct choices. First, the Bills market could continue to function as an alternative to the interbank market. In this capacity, the Bills serve as a high quality credit instrument which is an alternative to private placements and which allows counterparty anonymity on financial statements. At the same time, because of the tax advantage of the Bills, this type of Bills market gives banks with a large HKD retail deposit base

* For a complete and exceptional discussion of market making and liquidity, see Sanford J. Grossman and Merton H. Miller, "Liquidity and Market Structure", Journal of Finance, Vol. 43, No. 3 (July 1988).

subsidized lending rates.

Second, the Bills market might eventually resemble the markets for government debt elsewhere, in which participation is widely dispersed, brokers are active, and the primary function of the instruments is as a portfolio management and hedging tool. It should be noted that under the former market structure, it is not likely that Bills would ever emerge as an economy-wide hedging instrument, as participation would be limited to a few participants and liquidity would be supplied to meet the demands of only those active participants.

The structural design of the market must be changed if the latter function of Bills is deemed important. To increase participation outside the banking sector, the MAB must make the changes discussed above. Alternatively, the MAB may wish to limit the extent of the Bills market to playing the role of a parallel interbank market, and such a function may be valid. However, assuming there is demand for a parallel interbank market, per se, then giving subsidized lending rates is unnecessary. If this type of market is demanded for its own right, then the yields should not deter investment significantly. As such, the taxation bias should still be eliminated.

Finally, a word of caution. To criticise the active Bills market participants as collusive or oligopolistic may be quite inaccurate. If indeed the economic function of the market is limited to a few participants, then it could hardly be construed as oligopolistic. Moreover, even if participation should be wider for efficiency reasons (i.e. the limited structure of the market prevents assets from being held by their most highly-valuing users), the market participants are not to blame. They are simply responding to the incentives which the MAB has given them in defining the structure of the market.

As economists have known for many years, the best way to discourage oligopoly is to encourage entry up the point where the market can remain viable. If, when such entry is allowed, it does not occur, then it is likely that the situation is competitive -- the economic rents accruing to the marginal firm are zero, hence there is no incentive to enter the market. Therefore, the ultimate blame for any market imperfections in the Bills market falls on the MAB. To find the extent of the market, the market participants must be given the appropriate incentives to discover it.

APPENDIX

Exchange Fund Bills Market Makers

Bank of America NT & SA

Bank of China

Bank of East Asia Ltd

BOT International (HK) Ltd.

Banque Paribas, Hong Kong

Chase Manhattan Bank

Citibank, NA

DKB Asia Ltd.

Hang Seng Bank Ltd.

The Hongkong & Shanghai Banking Corp.

Ltd.

IBJ Asia Ltd.

Jardine Fleming & Co. Ltd.

Mitsubishi Finance (HK) Ltd.

Nanyang Commercial Bank Ltd., HK

Nomura International (HK) Ltd.

Sanwa International Finance Ltd.

Schroders Asia Ltd.

Standard Chartered Bank

Wardley Ltd.

Wing Lung Bank Ltd.

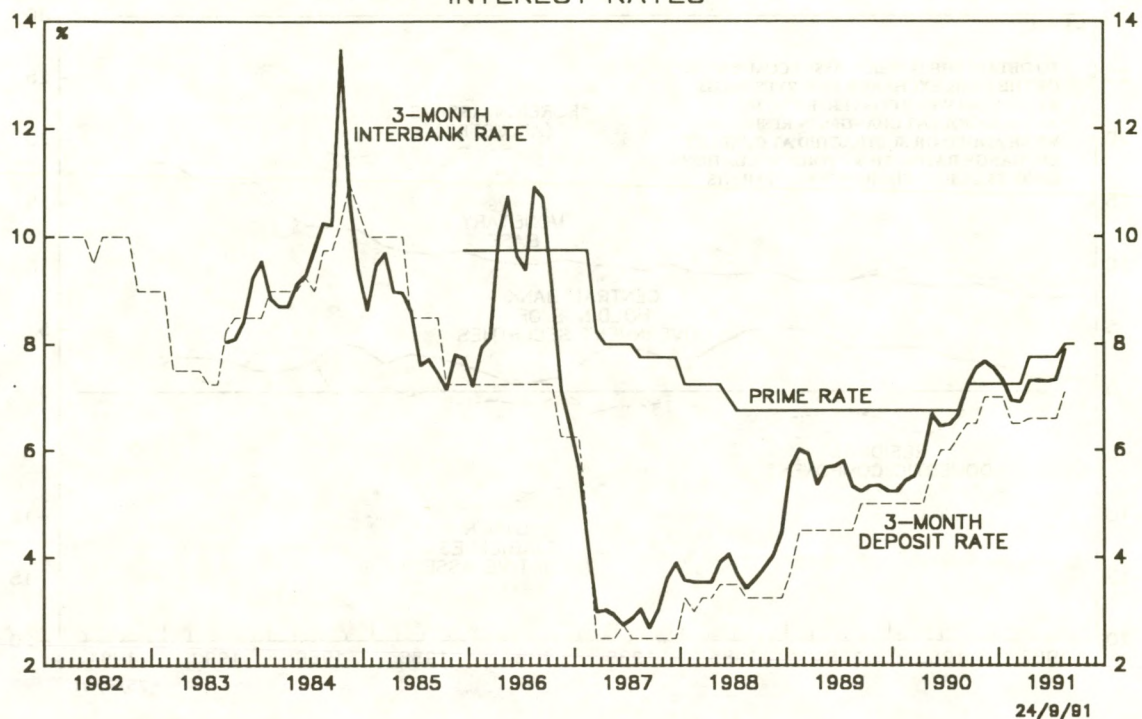
MALAYSIA MONETARY POLICY REMAINS TOO LOOSE

Since the latter half of 1990, the Malaysia central bank, Bank Negara (BN), has been ostensibly tightening monetary policy as the monetary expansion of 1989-90 (see AMM Vol. 15 No. 1) has manifested itself in the form of rising inflation and a rapidly deteriorating current account deficit. However, this monetary tightening can only be described as tentative and despite a deceleration in the monetary aggregates, underlying liquidity conditions remain easy while real domestic demand continues to expand in excess of 10% per annum.

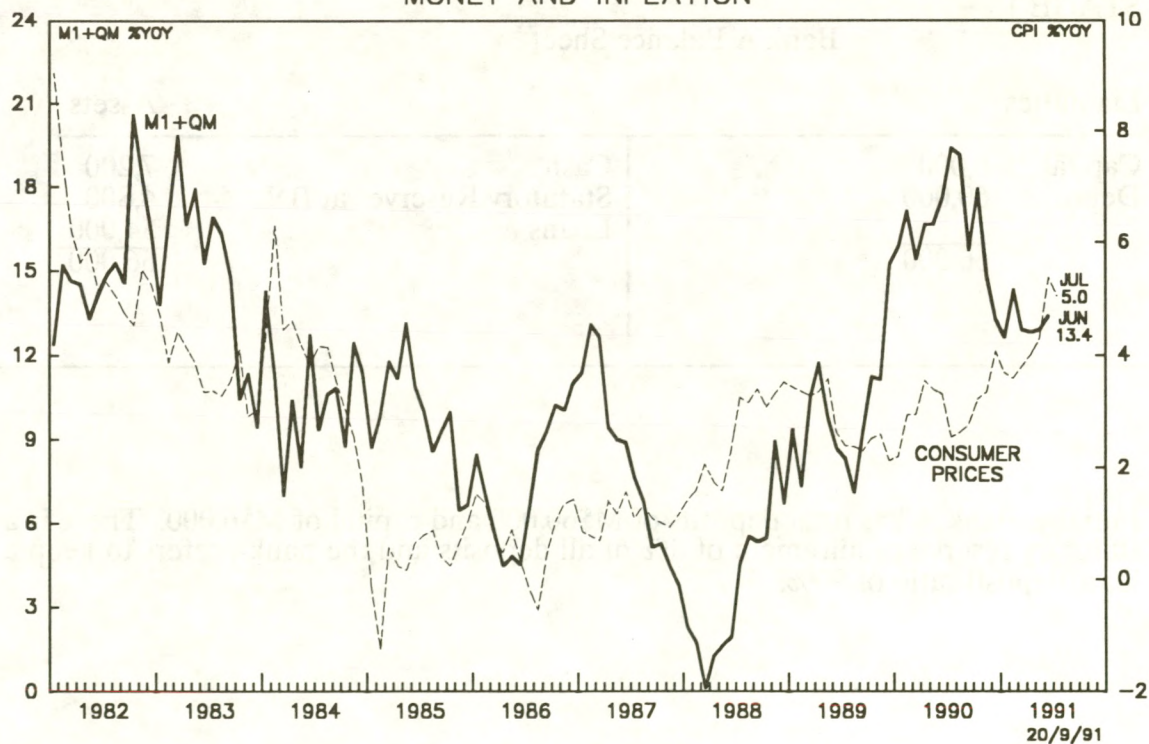
Although interbank rates have been trending upwards since early 1990 and prime rates have been raised three times since August 1990 from 7% to 8% (Chart 1), inflation has been rising faster and as a result real interest rates have been falling. CPI inflation has accelerated from under 3% as recently as September 1990 (Chart 2), to its current rate of 5%, primarily as a consequence of the aforementioned monetary expansion which has been exacerbated by a tight labour market and infrastructural bottlenecks. Nevertheless, on first examination, the rise in nominal interest rates appears to have been successful in moderating the growth of money supply. M1 + Quasi-Money has decelerated from a peak of 19.4% in July 1990 to 13.4% while the broader M3 which peaked earlier at 27.8% in December 1989 has slowed to 15.8%. However, looking beyond these headline aggregates reveals a very different picture.

The growth of the monetary base, which in Malaysia consists of currency in circulation plus deposits of banks and finance companies (some countries only include deposits of certain banks in their base definition), has slowed in line with the monetary aggregates and is currently expanding at around 13% y-o-y, down from a peak of over 30% at the end of Q3 1990. Malaysia continues to run an overall balance of payments surplus with the result that the expansion in the monetary base stems mainly from the accumulation of foreign assets (Chart 3). The domestic component is still contracting to sterilise partially this foreign asset growth. BN holdings of government securities have halved from M\$3 billion at the end of Q3 1990 but by far the largest source of the reduction in the domestic component has been the increase in the "other liabilities" of BN. Other liabilities increased from M\$10.4 billion in September 1990 to M\$16.0 billion in March 1991 reflecting substantial BN borrowing from commercial banks in the interbank market. At the initial stage this represents a tightening in liquidity because commercial banks are obliged to lend new deposits to BN rather than the general public. In effect, BN has therefore increased reserve requirements or more precisely has created a secondary reserve account. However, to understand more fully this policy and the subsequent effect it has had on the Malaysian banking system, a simple worked example from the standpoint of a commercial bank, Bank A, is included.

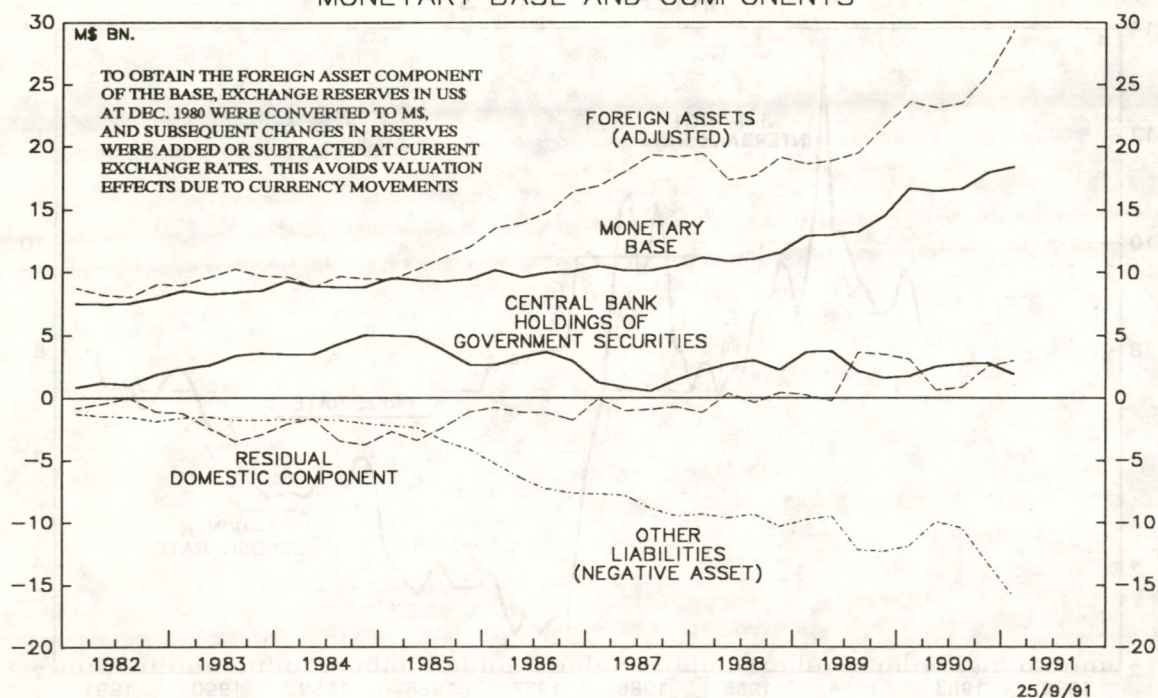
MALAYSIA: CHART 1
INTEREST RATES



MALAYSIA: CHART 2
MONEY AND INFLATION



MALAYSIA: CHART 3
MONETARY BASE AND COMPONENTS



STAGE 1

Bank A Balance Sheet

Liabilities

Capital	6,000
Deposits	60,000
	<u>66,000</u>

Assets

Cash	7,200
Statutory Reserves at BN	4,800
Loans	54,000
	<u>66,000</u>

Initially, Bank A has total deposits of M\$60,000 and capital of M\$6,000. There is a statutory reserve requirement of 8% of all deposits and the bank prefers to keep a loan/deposit ratio of 90%.

STAGE 2

Bank A Balance Sheet

Liabilities		Assets	
Capital	6,000	Cash	7,200
Deposits	62,750	Statutory Reserves at BN	5,020
		Secondary Reserves at BN	1,375
		Loans	55,155
	<u>68,750</u>		<u>68,750</u>

At Stage 2, an exporter deposits US\$1,000 at Bank A and Bank A in turn goes to BN with the US\$1,000 and receives M\$2,750 in return (an exchange rate of US\$1 = M\$2.75 is assumed). This is then credited to the deposit account of the exporter and the money stock expands by the same amount. Under normal circumstances the bank would then deposit $0.08 \times 2,750 = \text{M\$}220$ with BN as a statutory reserve, lend $0.9 \times 2,750 = \text{M\$}2,475$ and keep the residual M\$55 as cash. Now BN wishes to partially sterilise this US\$1,000 inflow, but has no holdings of government or central bank paper to sell to either the exporter or to Bank A. Selling paper to the exporter would instantly contract the money stock while selling paper to Bank A would restrict its ability to lend and thus its ability to create extra deposits and boost future money stock. In the absence of paper to sell, BN can therefore only sterilise by raising reserve requirements and in this case it in effect imposes a 50% secondary reserve ratio on new foreign exchange deposits by borrowing these deposits in the interbank market. This leaves only M\$1,155 available for lending assuming cash is not run down, and the bank's loan/deposit ratio falls.

STAGE 3

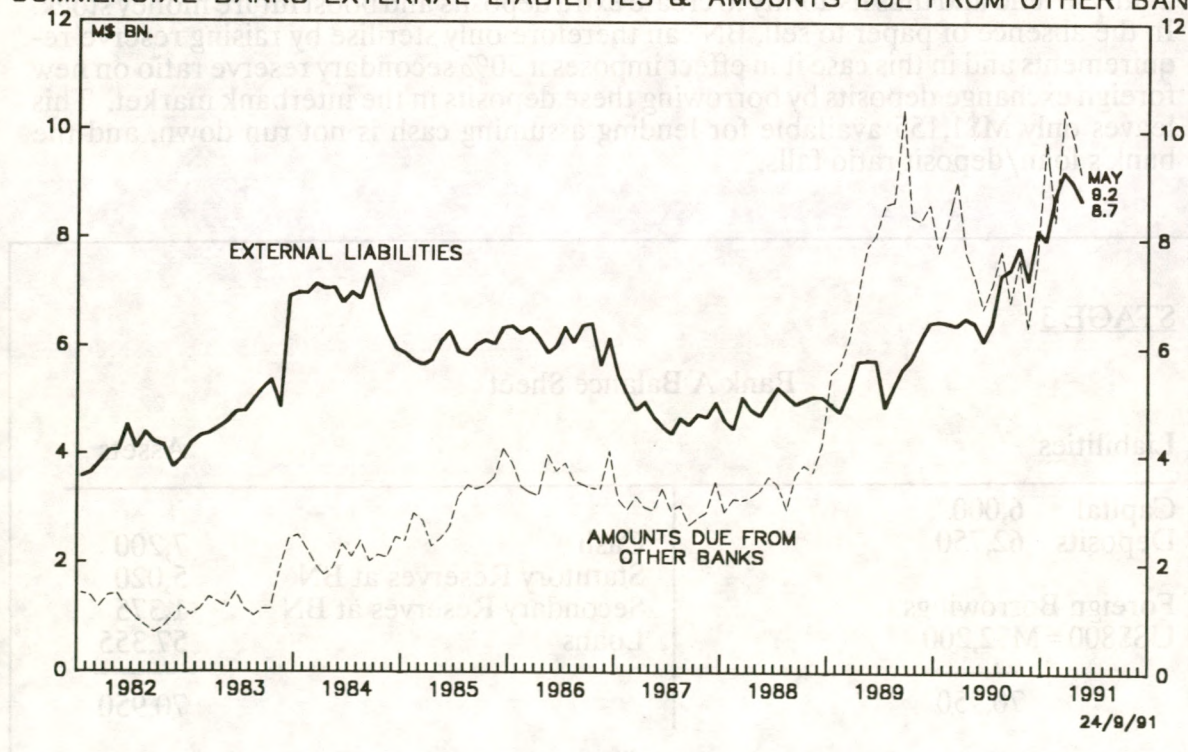
Bank A Balance Sheet

Liabilities		Assets	
Capital	6,000	Cash	7,200
Deposits	62,750	Statutory Reserves at BN	5,020
Foreign Borrowings		Secondary Reserves at BN	1,375
US\$800 = M\$2,200		Loans	57,355
	<u>70,950</u>		<u>70,950</u>

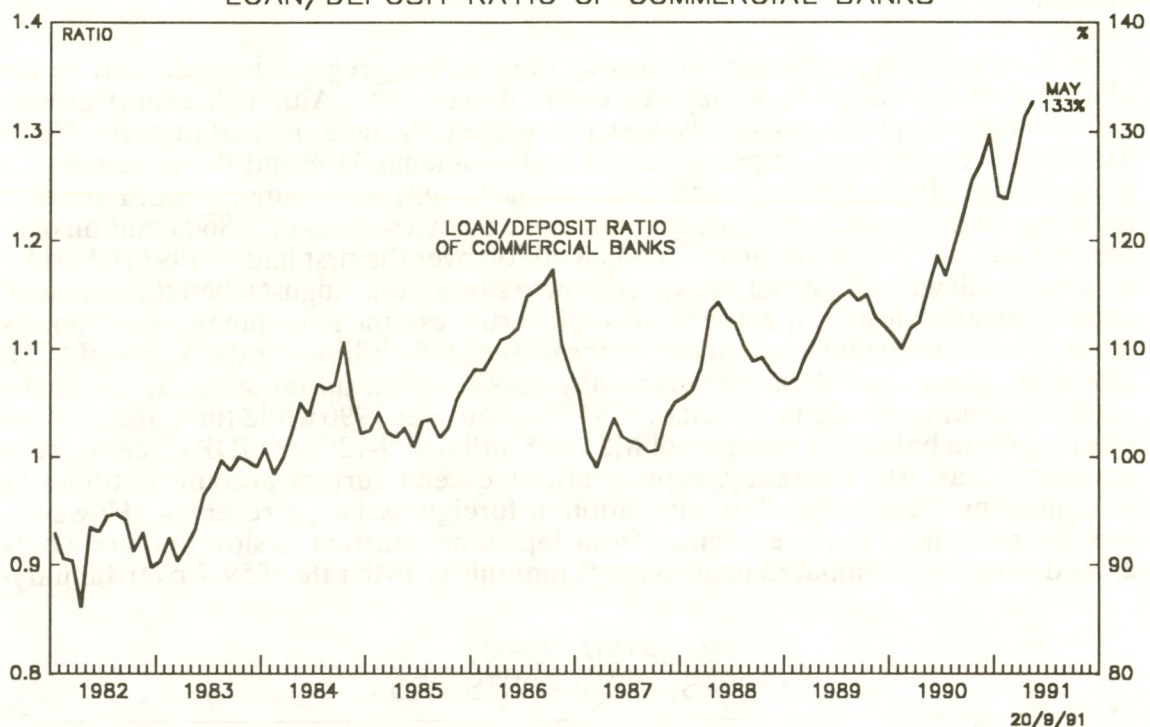
At Stage 3, Bank A decides that as the secondary reserve at BN has been created by interbank borrowings, it is likely to get these funds back at some stage unless BN rolls over the borrowings indefinitely or raises statutory reserve requirements (in fact BN did raise reserve requirements by 1% to 7.5% on August 14th draining approximately M\$1.1 billion from the system). It therefore decides to run an open position, borrows US\$800 offshore and lends the equivalent in M\$ boosting its loan/deposit ratio to 91.4%. Initially, the holding of a US\$ liability has no effect on money stock but ultimately money stock must increase as the proceeds of the new loans are deposited within the banking system.

This simple example broadly reflects recent developments in the Malaysian banking system. The increase in BN borrowings from commercial banks is reflected in the rise of commercial bank external liabilities (Chart 4). As a result, the loan/deposit ratio of commercial banks has climbed sharply since the end of 1990 (Chart 5). Much of the increase in the loan/deposit ratio since the beginning of 1990 reflects bank lending against extra capital raised, but the final step up is mainly due to this surge in offshore borrowing. This in turn explains the divergence between money and credit growth (Chart 6). Total credit advanced by banks and finance companies continues to grow well in excess of 20% per annum while in certain areas -- notably hire purchase loans (54.4% y-o-y) and credit card loans (70% y-o-y) -- the growth is even more torrid. Longer term, one can expect money growth to start to accelerate

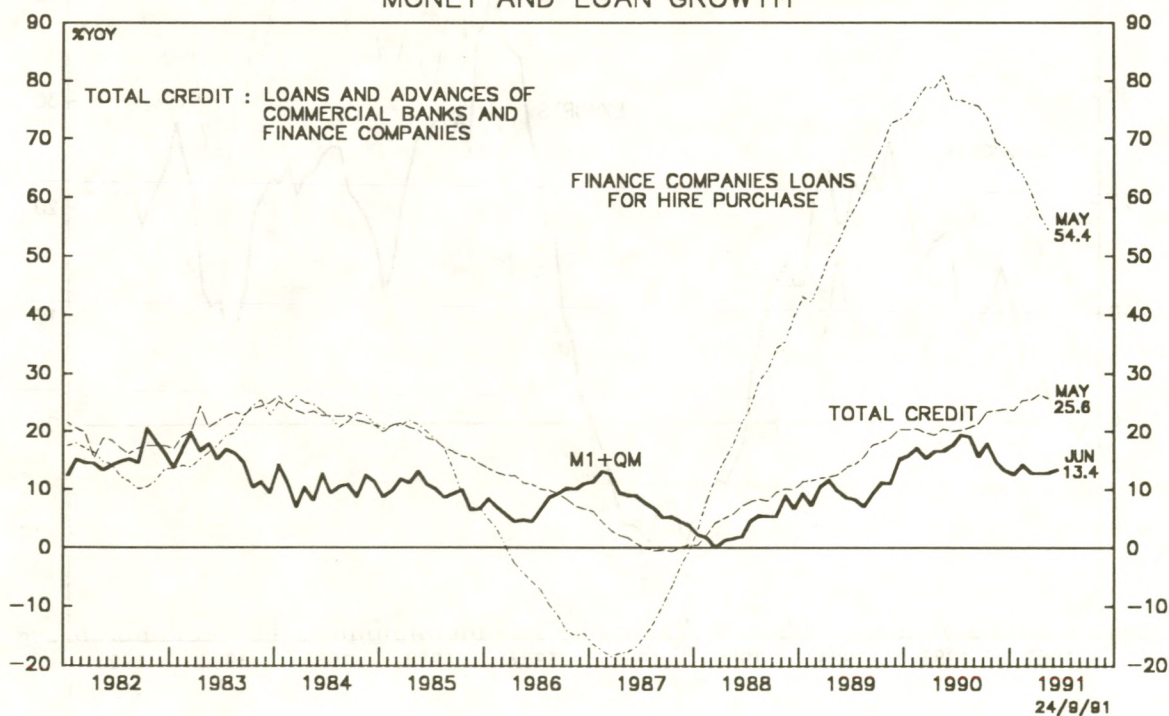
MALAYSIA: CHART 4
COMMERCIAL BANKS EXTERNAL LIABILITIES & AMOUNTS DUE FROM OTHER BANKS



MALAYSIA: CHART 5
LOAN/DEPOSIT RATIO OF COMMERCIAL BANKS



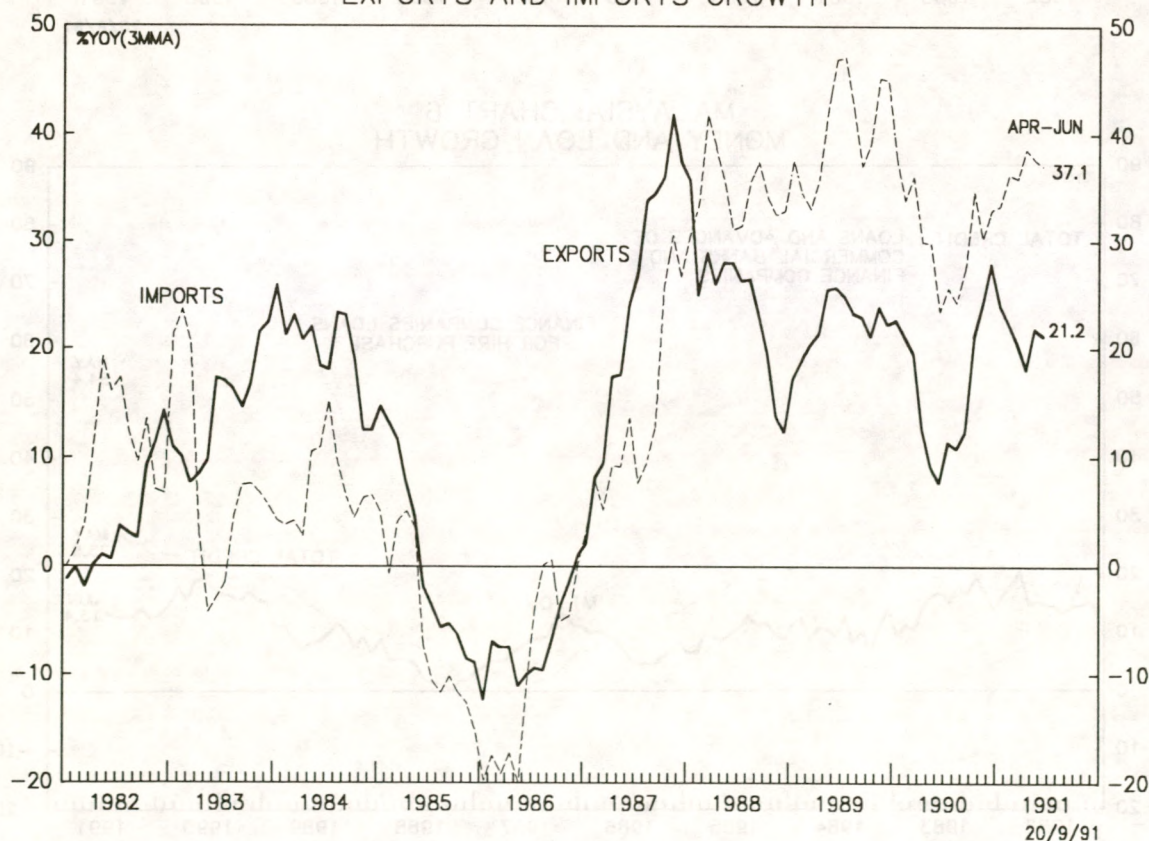
MALAYSIA: CHART 6
MONEY AND LOAN GROWTH



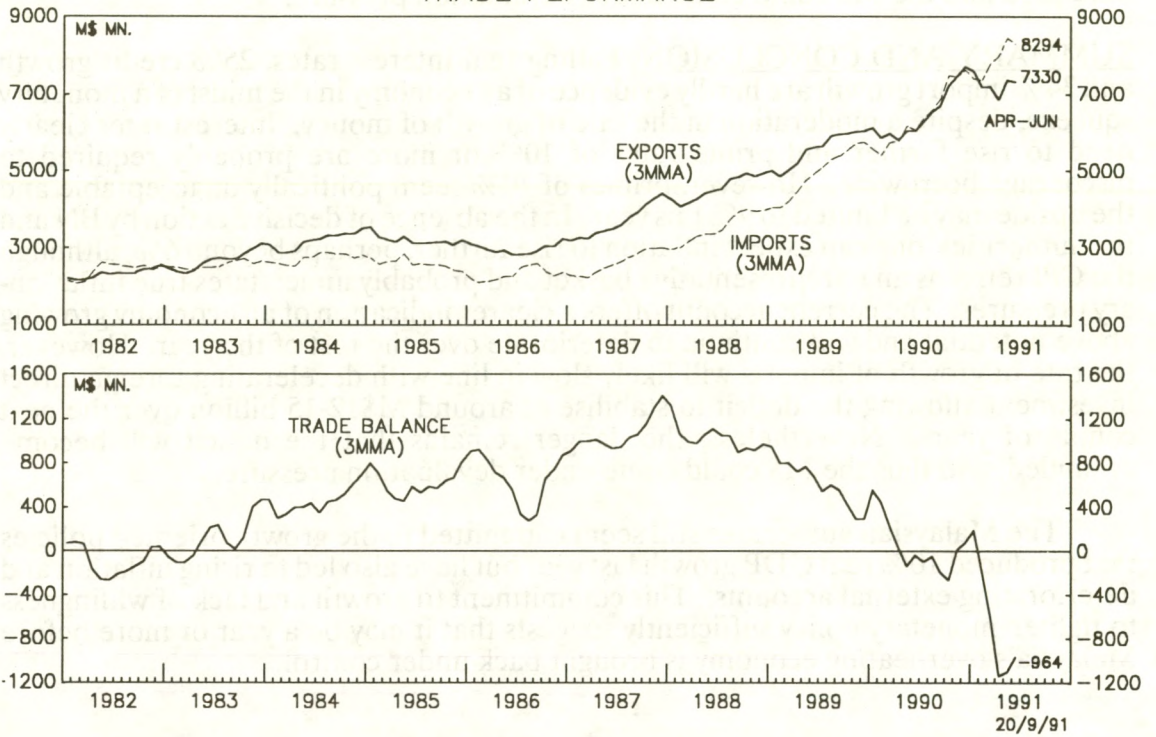
again as this incremental credit filters back into the banking system in the form of new deposits.

Easy liquidity in the face of slowing monetary aggregates is evidenced by the alarming deterioration in Malaysia's external accounts. Although export growth remains robust, it has consistently been outstripped by the growth of imports (Chart 7). In the year to June, imports grew at a phenomenal 34% and the government's prediction in March of 16% growth for the whole of 1991 now seems absurd. Excessive import growth has seen the trade account move from a surplus of M\$603 million over the first half of 1990 to a deficit of M\$4.68 billion over the first half of 1991 (Chart 8). This may well worsen further as export growth slows from August when the rise in oil export revenues drops out of the figures. Nevertheless, the government is stubbornly sticking with its current account deficit forecast of M\$8 billion for the whole of 1991. However, given that Malaysia perennially runs a deficit on invisibles and that the current account recorded a deficit of M\$4.7 billion over 1990 while the trade account was roughly in balance, a shortfall of M\$12-15 billion -- 9-12% of GDP -- seems more realistic (Chart 9). Currently, capital inflows exceed current account outflows as evidenced by the continued accumulation of foreign exchange reserves. However, foreign investment flows, especially from Japan, are starting to slow and grew only 2.7% during June compared to an average monthly growth rate of 59% over January-

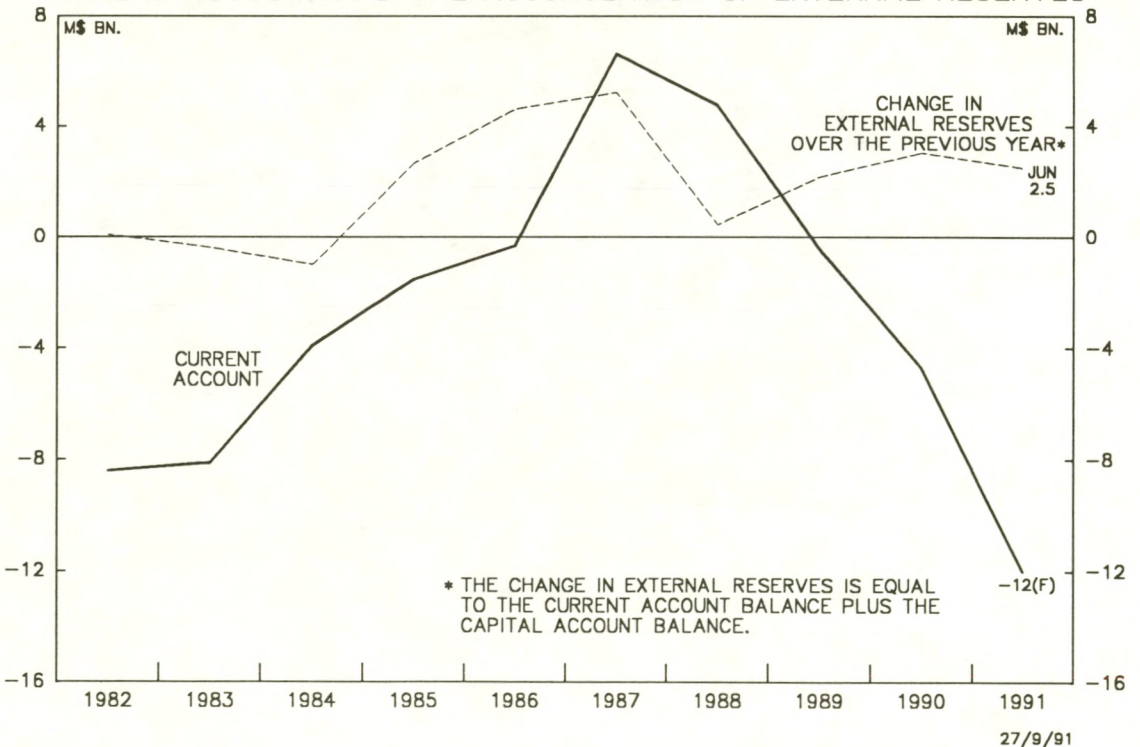
MALAYSIA: CHART 7
EXPORTS AND IMPORTS GROWTH



MALAYSIA: CHART 8
TRADE PERFORMANCE



MALAYSIA: CHART 9
CURRENT ACCOUNT AND THE ACCUMULATION OF EXTERNAL RESERVES



May. Should these trends continue, the current account deficit will quickly become unfunded and the M\$ could come under devaluation pressure.

SUMMARY AND CONCLUSION: Falling real interest rates, 25% credit growth and 34% import growth are hardly evidence of an economy in the midst of a monetary squeeze, despite a moderation in the rate of growth of money. Interest rates clearly need to rise further and prime rates of 10% or more are probably required to discourage borrowing. However, primes of 10% seem politically unacceptable and the upside may be limited to 9% this year. In the absence of decisive action by BN and the authorities, one can expect inflation to rise further, perhaps beyond 6%, although the CPI remains an unrepresentative basket and probably understates true inflationary pressures. The current account offers a clearer indication of an economy growing above potential and will continue to deteriorate over the rest of the year. However, the rate of growth of imports will likely slow in line with decelerating foreign direct investment allowing the deficit to stabilise at around M\$12-15 billion over the next couple of years. Nevertheless, the danger remains that the deficit will become unfunded, and thus the M\$ could come under devaluation pressure.

The Malaysian authorities still seem committed to the growth oriented policies that produced 10% real GDP growth last year but have also led to rising inflation and deteriorating external accounts. This commitment to growth and lack of willingness to tighten monetary policy sufficiently suggests that it may be a year or more before Malaysia's overheating economy is brought back under control.



SINGAPORE: ECONOMY SLOWS DOWN, CREDIT TO EASE

Introduction

This article analyses the factors which are affecting movements in the stock of money and bank loans in Singapore in the context of the business cycle of the economy.

The Singaporean economy has been slowing down right through 1991. The GDP growth rate fell from 7.5% during the first quarter to 7% in the second and finally to 6% during the third. The overall growth of the economy for 1991 is officially forecast between 6% to 8%, down from the 8.3% p.a. growth achieved in 1990.

The electronics industry is bearing the main brunt of the slowdown in the manufacturing sector. Exports to US have declined including disk drives and computer peripherals. Chart 1 gives a broad version of the performance of exports as it includes oil products and re-exports. Chart 2 which concentrates on domestic exports only shows that the decline started during the first quarter of 1990 and continues undiminished to date. Retained imports, which can be interpreted as a reasonable leading indicator, started their steep decline during December 1990. In fact during August and September 1991 retained imports actually declined (negative growth) by 1.3% and 5.2% y-o-y respectively. These figures do not show up in Chart 2 as growth rates are calculated on a three month moving average basis.

Retail sales have also declined continuously since the last quarter of 1990 (Chart 3). Credit started to tighten at the start of 1990. As Chart 4 shows the growth rate of M2 declined from the end of 1990 Q1 and it was followed soon afterwards by a fall in the growth of bank loans. The "spikes" in Chart 4 were the temporary effects on the growth rate of M2 and loans of new equity issues being offered in the market. Interbank interest rates rose from 1989 Q3 until August 1990 (Chart 5). After a period of falling interbank rates during August 1990 -- February 1991, rates fell again from July 1991 to date. Prime rates, however, rose at the start of 1990 and stayed, in general, at high levels (Chart 5).

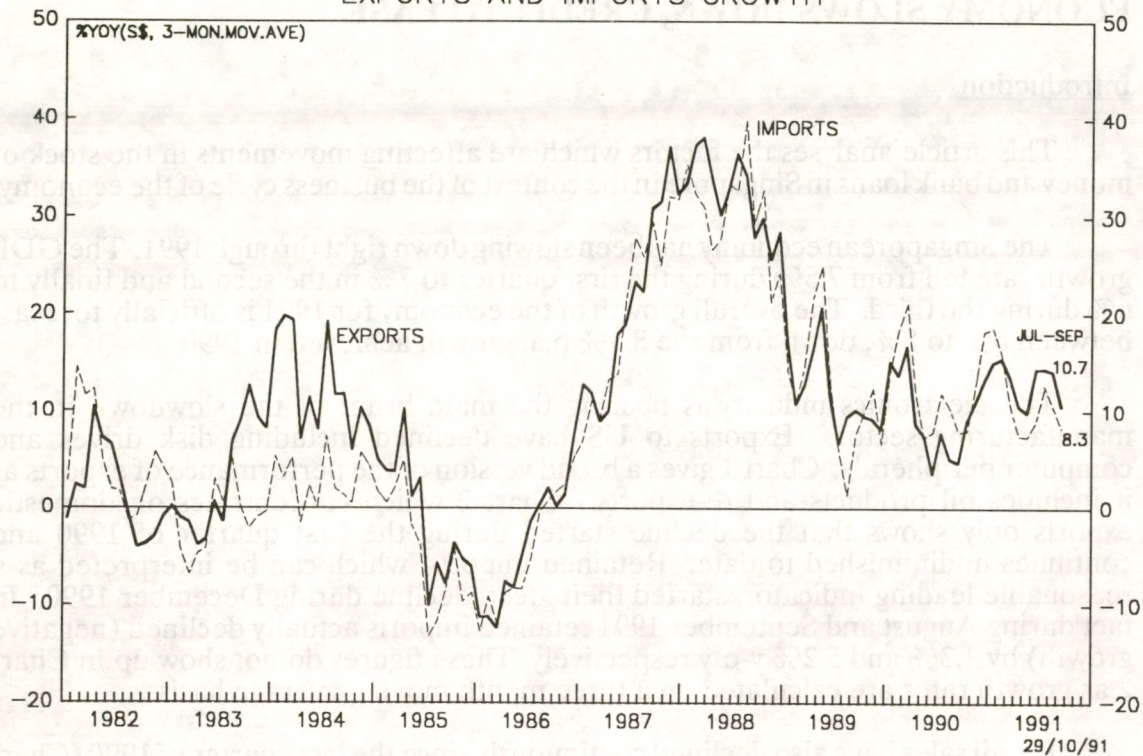
The behaviour of both interbank and prime interest rates from 1989 to 1990 Q2 are consistent with an expanding economy and rising credit demand. When the economy began to weaken during 1990 Q4 (see Chart 3), the easier interbank rates since 1991 Q2 could be explained by a subsequently softer demand for credit.

In analysing the behaviour of both monetary and credit aggregates as well as interest rates, it is well worth remembering that the Singaporean authorities target the exchange rate as their main policy instrument to control inflation. The movements in domestic interest rates must therefore take into account the movements of US dollar interest rate as well as the overall credit conditions in the economy.

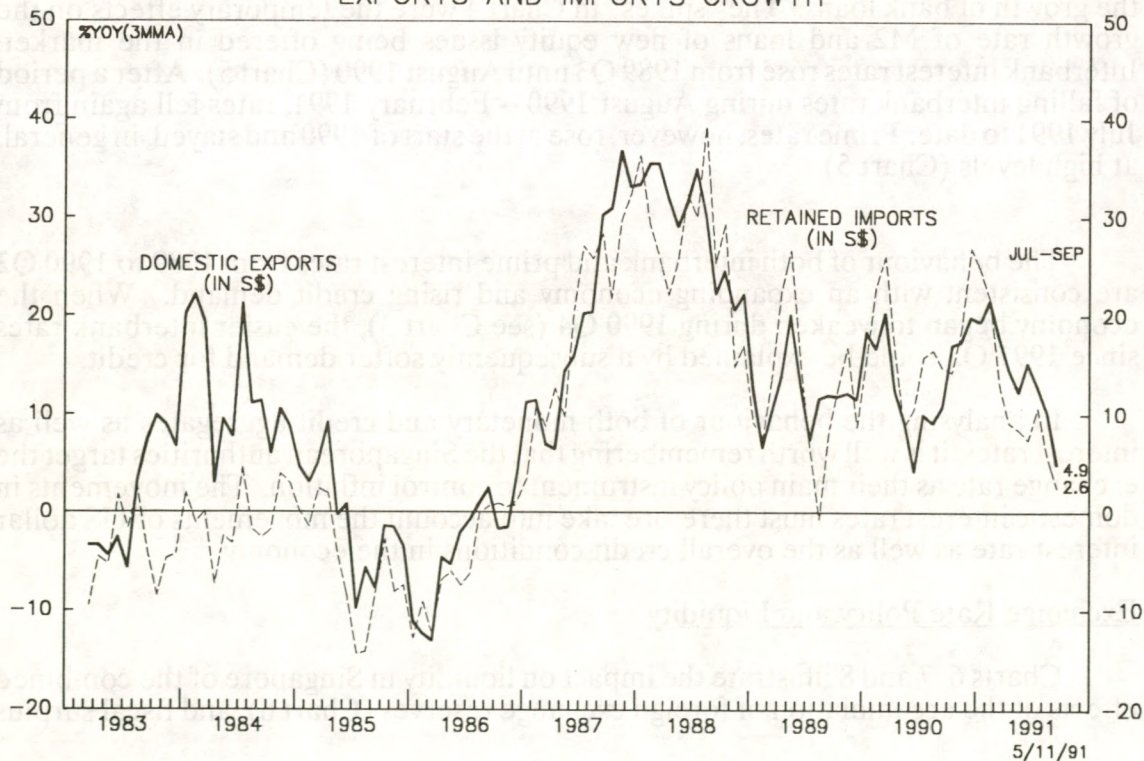
Exchange Rate Policy and Liquidity

Charts 6, 7 and 8 illustrate the impact on liquidity in Singapore of the combined effects of the accumulation of foreign exchange reserves (Chart 6), and fiscal surplus

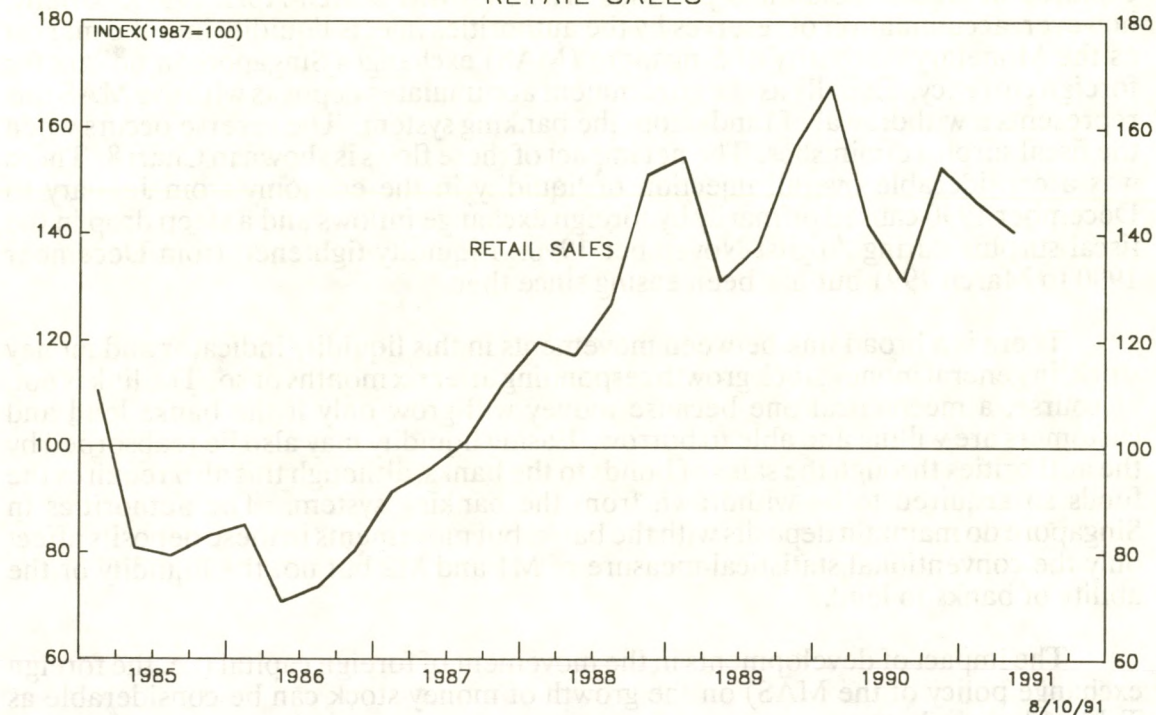
SINGAPORE: CHART 1
EXPORTS AND IMPORTS GROWTH



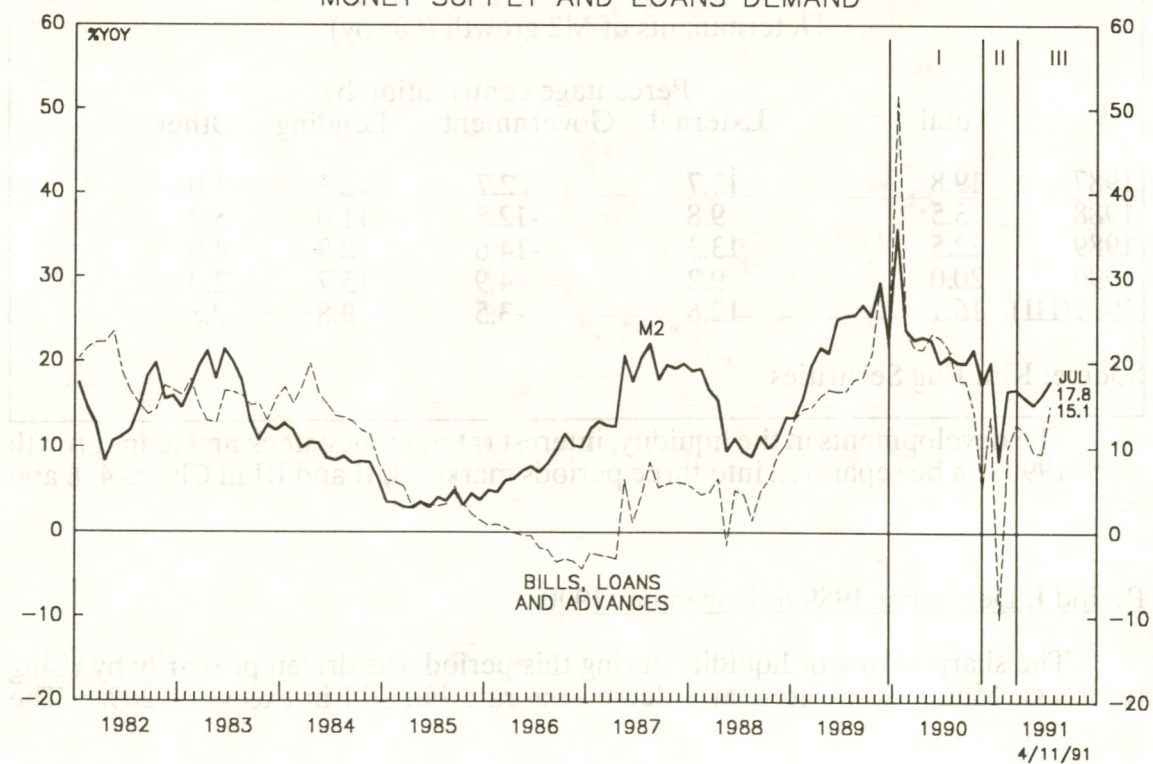
SINGAPORE: CHART 2
EXPORTS AND IMPORTS GROWTH



SINGAPORE: CHART 3
RETAIL SALES



SINGAPORE: CHART 4
MONEY SUPPLY AND LOANS DEMAND



(Chart 7). The interactions and mechanics of these particular flows have been explored in greater detail in a previous article (AMM March-April 1991). Briefly, however, accumulation of reserves by the authorities injects liquidity into the market as the Monetary Authority of Singapore (MAS) exchanges Singaporean dollars for foreign currency. Equally as the government accumulates deposits with the MAS this represents a withdrawal of funds from the banking system. The reverse occurs when the fiscal surplus diminishes. The net impact of these flows is shown in Chart 8. There was a considerable overall injection of liquidity in the economy from January to December 1990 caused primarily by foreign exchange inflows and a steep drop in the fiscal surplus during August-November 1990. Liquidity tightened from December 1990 to March 1991 but has been easing since then.

There is a broad link between movements in this liquidity indicator and money stock, in general money stock growth responding after six months or so. The link is not, of course, a mechanical one because money will grow only if the banks lend and customers are willing and able to borrow. Easing liquidity may also be reabsorbed by the authorities through the sales of bonds to the banks, although this also requires the funds so acquired to be withdrawn from the banking system. The authorities in Singapore do maintain deposits with the banks but movements in these deposits affect only the conventional statistical measure of M1 and M2 but not the liquidity or the ability of banks to lend.

The impact of developments in the movement of foreign capital (i.e. the foreign exchange policy of the MAS) on the growth of money stock can be considerable as Table 1 below shows:

Table 1
Determinants of M2 growth (% yoy)

	Total	Percentage contribution by			
		External	Government	Lending	Other
1987	19.8	13.7	2.7	2.3	1.0
1988	13.5	9.8	-12.5	11.0	5.2
1989	22.5	13.3	-14.6	18.9	4.9
1990	20.0	9.2	-4.9	13.7	2.0
1991(HI)	16.1	12.6	-3.5	9.8	-2.8

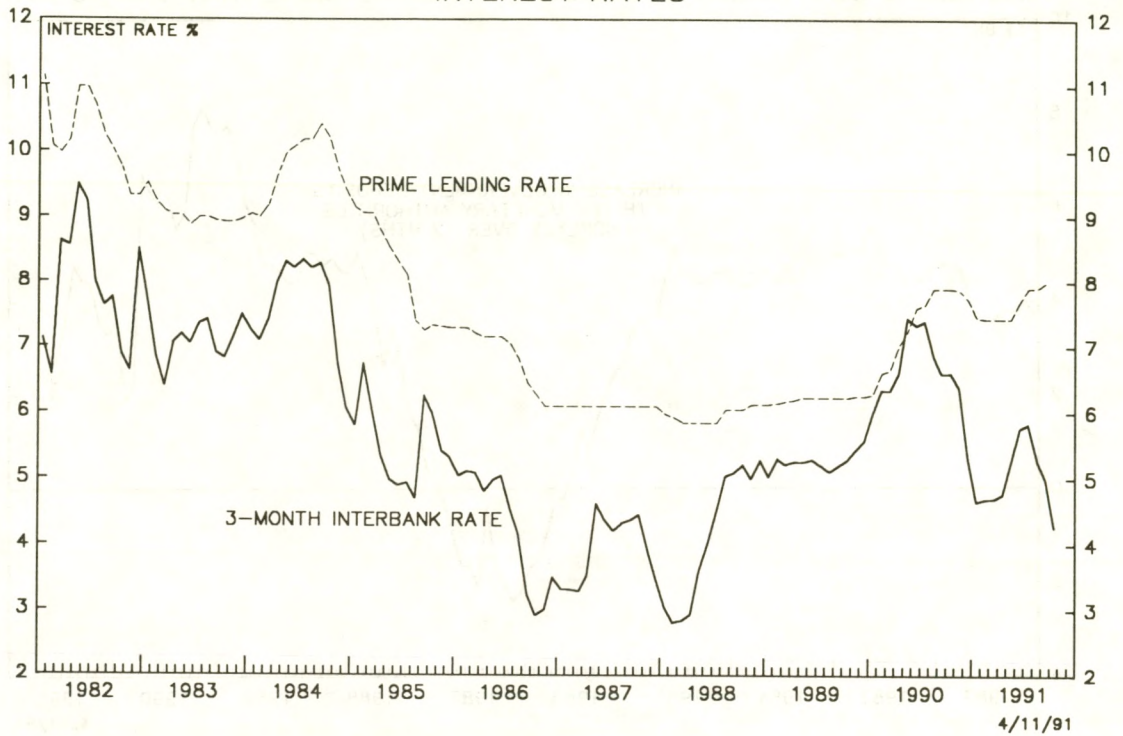
Source: Kim Eng Securities

The developments in the liquidity, interest rates, money stock and loans growth since 1990 can be separated into three periods marked I, II and III in Charts 4, 8 and 9.

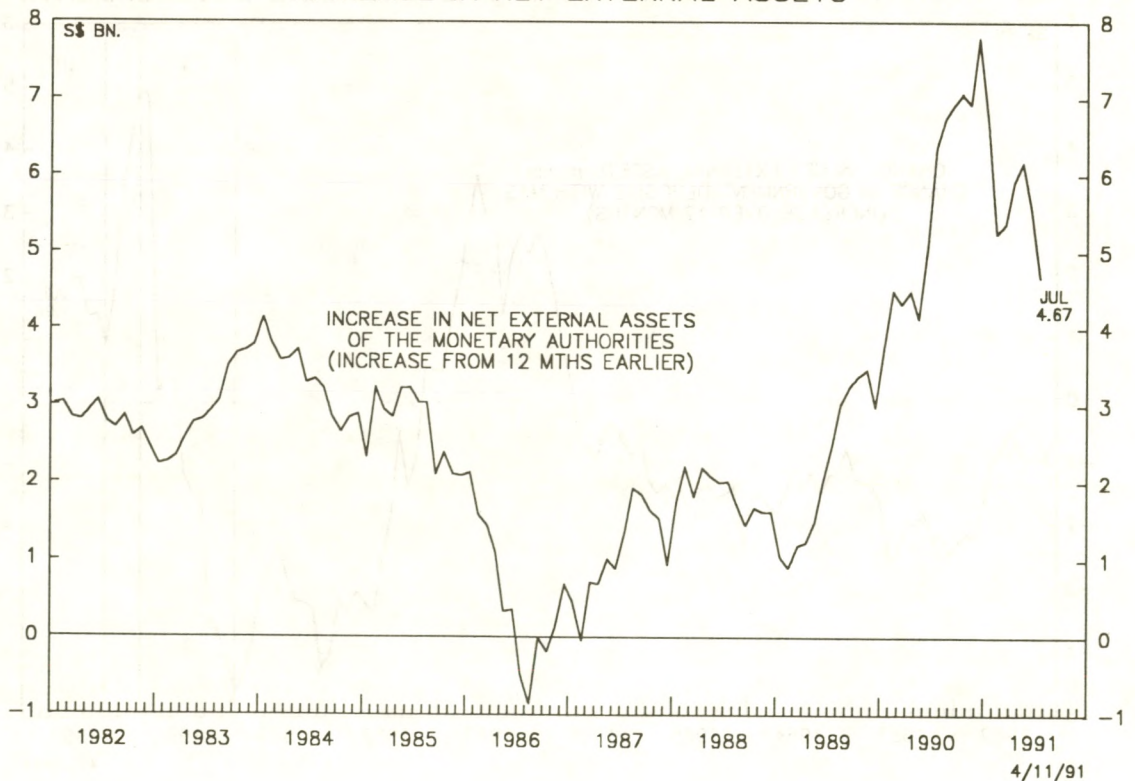
Period I, December 1989 to November 1990

The sharp easing of liquidity during this period was driven primarily by rising reserves. Money stock grew at a decreasing rate but still in excess of 20%. The

SINGAPORE: CHART 5
INTEREST RATES



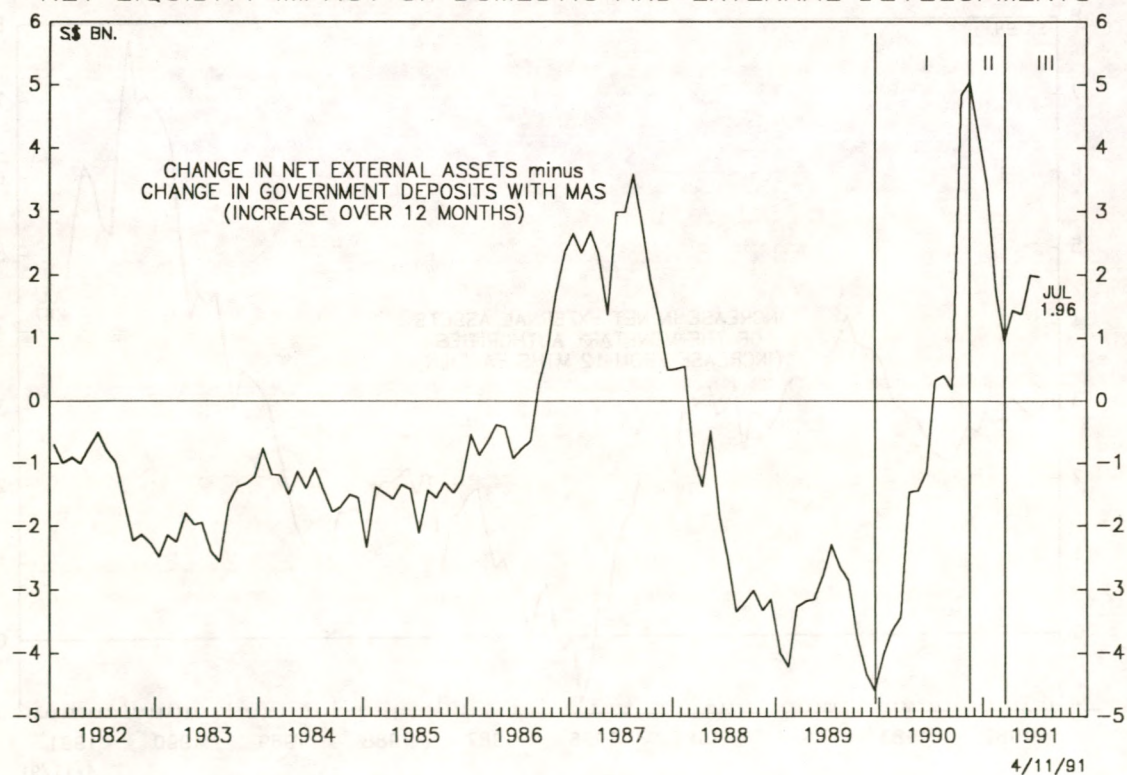
SINGAPORE: CHART 6
INCREASE IN NET EXTERNAL ASSETS



SINGAPORE: CHART 7
INCREASE IN GOVERNMENT DEPOSITS WITH THE MONETARY AUTHORITIES



SINGAPORE: CHART 8
NET LIQUIDITY IMPACT OF DOMESTIC AND EXTERNAL DEVELOPMENTS



Singaporean dollar appreciated throughout this period with interest rate differentials falling from September 1989 to July 1990 and then rising to December 1990. The increasing rate of the accumulation of reserves, the appreciation of the Singaporean dollar and, eventually, rising interest rate differentials are all consistent with the MAS capping the appreciation of the Singaporean currency against the US dollar.

Period II November 1990 - March 1991

Liquidity decreased sharply as the accumulation of foreign exchange reserves declined. The Singaporean dollar weakened and, approximately, at the same time interest rate differentials fell, all events being consistent with the MAS undertaking a support operation for the currency.

Period III, March to October 1991

The easing of liquidity during the initial stages of this period had been driven more by a lower fiscal surplus than by the accumulation of foreign exchange reserves. The increase in interest rate differentials since July 1991 and the slowing down in the accumulation of reserves could be indicative of the MAS wishing to maintain a relatively neutral position towards the currency by intervening less in the foreign exchange market but also letting interbank rates drift downwards. Significantly during May-June the declining growth of both M2 and bank loans appears to have bottomed out.

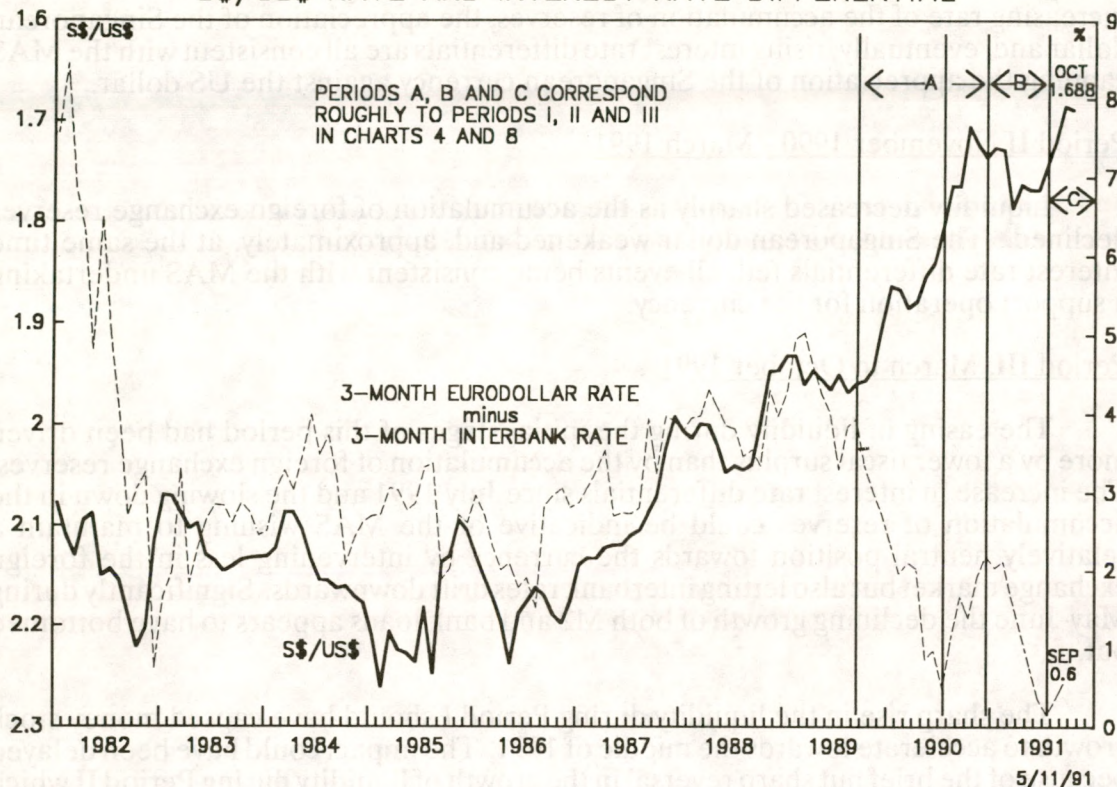
The sharp rise in the liquidity during Period I should have caused money stock growth to accelerate towards the middle of 1991. The impact could have been delayed because of the brief but sharp reversal in the growth of liquidity during Period II which also coincided with the Gulf crisis and the rise in domestic interest rates during the first half of 1991. During these three periods MAS behaved broadly consistently with its avowed aim to control the exchange rate capping its appreciation where necessary and supporting it when weakening. As Chart 9 shows the falling inflationary trends in Singapore may allow the MAS some leeway in its exchange policy. With domestic exports growth still weak, any further appreciation of the Singaporean dollar may well be resisted, thus adding liquidity to the system. Any weakness, however, may not, thus having little or no impact on liquidity.

Bank Loans and Bank Deposits

When bank deposits are growing faster than bank loans, banks are simply expanding assets which are unrelated to private sector lending. It is theoretically possible for bank loans not to grow at all whilst deposits increase. For example, banks could lend to the government by buying up government bonds, the government spending the proceeds at home. Over the cycle it is also likely for loans to grow faster than deposits in the upturn and slower than deposits when the economy slows down.

As Chart 11 shows the steep decline in the growth of deposits since the third quarter of 1990 had been preceded by that of loans in the second quarter of that year.

SINGAPORE: CHART 9
S\$/US\$ RATE AND INTEREST RATE DIFFERENTIAL



SINGAPORE: CHART 10
INFLATION

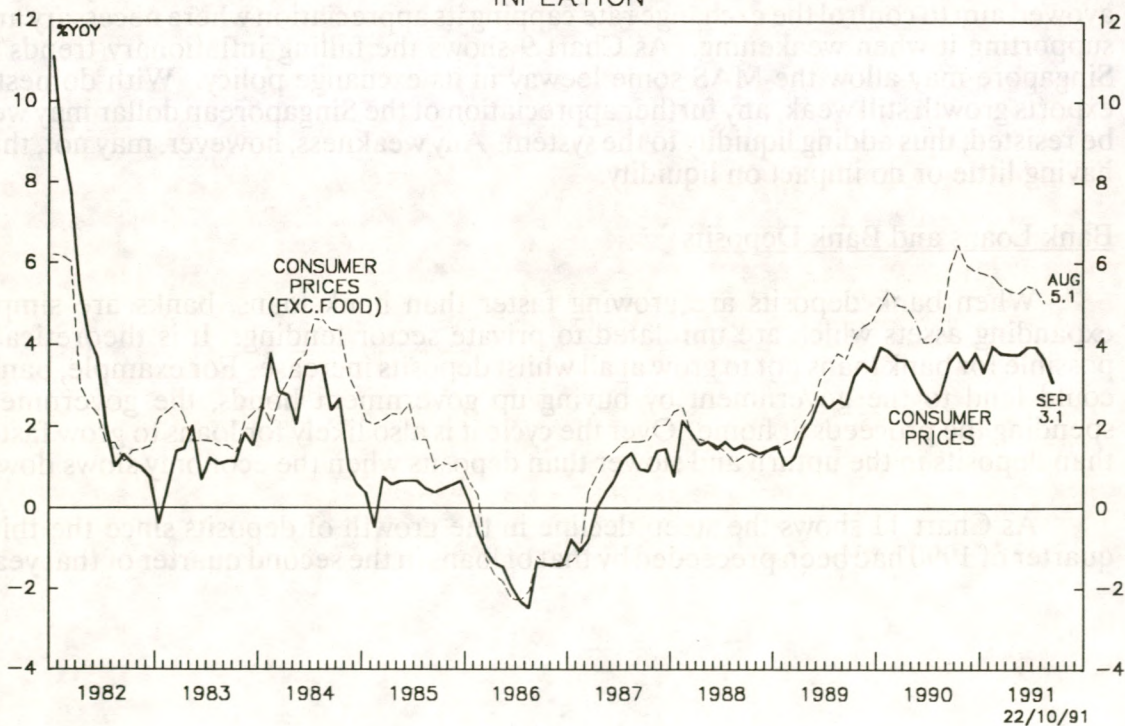


Table 2

Changes in the Structure of Assets of Banks in Singapore
(% of total and % yoy growth)

	Loans		Interbank Loans (*)		Securities	
	% share	% yoy	% share	% yoy	% share	% yoy
1986	46.5	-	36.4 (27.7)	-	7.0	-
1987	43.7	5.8	39.1 (28.4)	20.9	9.8	56.4
1988	43.3	10.5	39.5 (30.3)	12.6	9.3	6.1
1989	39.9	21.3	44.9 (33.0)	50.0	8.5	19.5
1990	43.0	13.6	41.1 (27.4)	-3.5	9.2	14.3
1991 (July)	47.2	15.0	35.6 (25.9)	5.3	10.1	16.2

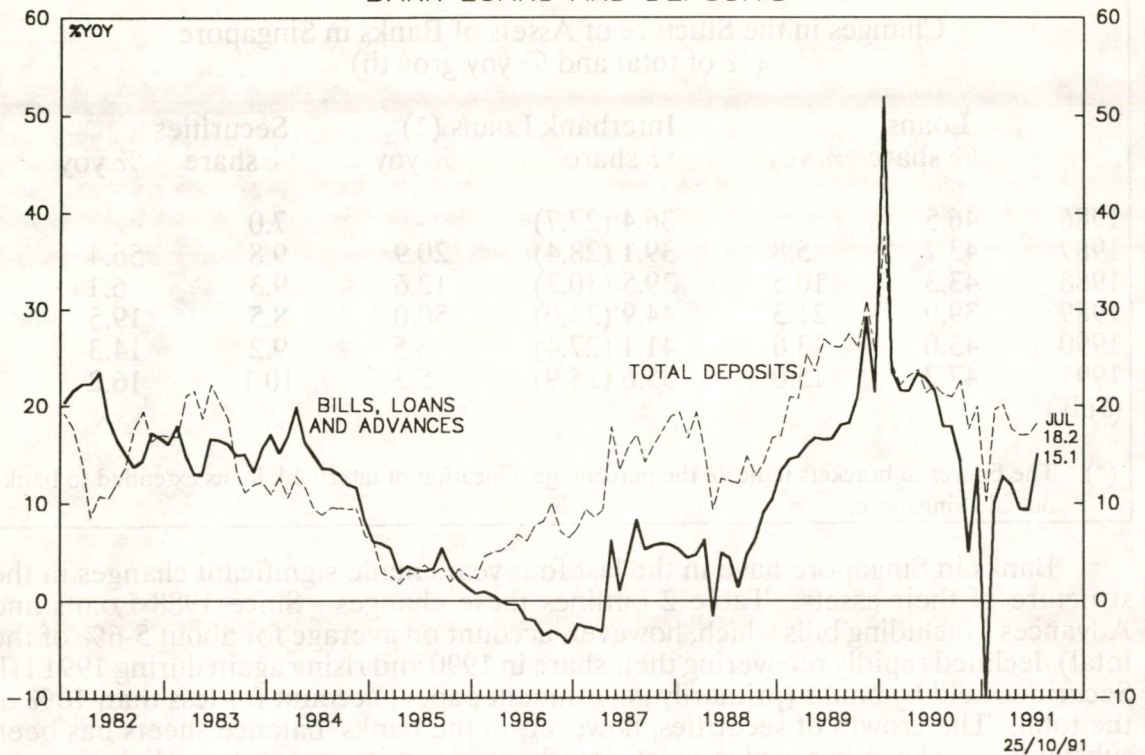
(*) The figures in brackets indicate the percentage allocation of interbank loans extended to bank outside Singapore.

Banks in Singapore have in the last four years made significant changes in the structure of their assets. Table 2 outlines these changes. Since 1988 Loans and Advances (including bills which, however, account on average for about 5-6% of the total) declined rapidly recovering their share in 1990 and rising again during 1991 H1. Securities held by banks (primarily government paper) account for less than 10% of the total. The growth of securities, however, in the banks' balance sheets has been substantial. The other major asset, interbank deposits, presents a slightly more complex picture. Strictly speaking the sum total of interbank loans (an asset) should be equal to interbank deposits (a liability) for those transactions which take place within Singapore. In fact, the official MAS statistics do not add up to zero producing an average annual discrepancy of about S\$640 ml (1986-1990). This can be caused by statistical errors and discrepancies in the timing of the reports. Table 2 nets out the interbank loans made to bank outside Singapore, which as the numbers show, are proportionately by far the more important activity in the interbank market. The net inflows (deposits accepted from, minus loans extended to, banks outside Singapore) comes to an average annual of S\$1.7 bn (1986-1991 H1). The figures in Table 2 indicate that interbank activity either on an aggregate (domestic plus foreign) or simply foreign basis moved in the opposite direction to that of loans and advances. Overall, however, since 1990 the proportion of the banks' assets dedicated to loans has been growing.

Given the surplus in the fiscal position of the Singaporean government any increase in the amount of government debt that the banks are holding would have simply tended to push interest rates up. In any case the deposits of the Singaporean government and of other statutory authorities with banks have remained a steady 20.5% - 21.5% of total deposits during 1990-1991 (July) after a rise to nearly 26% in 1988.

The monthly statutory liquidity position of banks during 1990 and 1991 (July) has been broadly constant, with banks maintaining their position very closely to the minimum 18% required.

SINGAPORE: CHART 11
BANK LOANS AND DEPOSITS



The picture which emerges from the analysis of the causes of the growth of loans and advances during 1990 and 1991 points to a weak borrower's demand rather than unwillingness on the part of banks to lend. There has been no major shift in the structure of bank assets nor are there any other class of assets in direct competition with loans to the private sector.

A Synthesis and Conclusions

Since the start of 1990 the overall behaviour of the growth of money stock, credit and of interest rates in Singapore has been consistent with the broad cyclical movements of the economy. The fluctuations in interest rates during the first three quarters of 1991 are also consistent with the monetary policies pursued by the Singaporean authorities.

There are indications that the decline in the growth rates of loans and money stock may well have bottomed. The behaviour of the liquidity indicators in the context of the foreign exchange rate policy pursued by the MAS also point to a period of continuing ease. Since the recovery in the growth of exports from Singapore will be dependent on the recovery of the economy of the US, and this appears to be increasingly delayed, demand for loans may remain soft and hence interest rates will continue to fall. Demand for loans from the property sector has remained quite buoyant, and in an environment of falling interest rates, may help to sustain the recovery in the growth of loans in general.

